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BOOK REVIEWS

Controllership. The Work of the Accounting Executive.

By J. Brooks Heckert and James D. Willson. THE RONALD PRESS CO., New York, N. Y., 1952. Pages: xi + 645; $7.50.

The purpose of this book is to provide an "integrated and comprehensive treatment of controllership as a distinct business function." The volume presents in detail the duties and responsibilities of the controller.

The authors, both certified public accountants, are, respectively, Professor of Accounting at The Ohio State University, and Controller of one of the divisions of the Libbey-Owens-Ford Glass Company.

The volume is made up of five parts:

I. The Function of Controllership (2 chapters)

II. Accounting Control of Operations (18 chapters)

III. Accounting Reports (5 chapters)

IV. Administration of Controller's Department (6 chapters)

V. Other Problems of Controllership (6 chapters)

and includes 173 illustrations comprising statements, tables, charts, reports, and forms. These range from the traditional Sales Analysis by Customer and Class of Product (Figure 12) and Statement of Income and Expense by Territories (Figure 15) and by Products (Figure 16) to the more complex Distribution Cost Schedules (Chapter 6). The Aged Accounts Receivable Trial Balance (Figure 58) and the charts dealing with Profit Planning and Control (Figures 86 to 91) will be of particular interest to public accountants. Chapter 33, dealing with Tax Records and Procedure, also contains much timely material.

The relationships between internal auditing and controllership (Chapter 28) and between the controller and the public accountant (Chapter 37) are discussed at length. In considering the contribution of the internal auditors to the work of the public accountants the authors stress that coordination of the activities of these two groups of accountants will "provide the most complete over-all audit."

Distinguishing the work of the controller from that of the public accountant, the authors note that the controller (or chief accountant) "is primarily responsible for developing, installing, and operating an efficient and economical system of record keeping and internal control"; "the work of the independent public accountant," observe the authors, "should complement and supplement the work of the controller with a minimum duplication of effort."

Although the work is designed primarily for controllers and students of controllership, it contains much material of professional interest to the public accountant. The book will help him understand the point of view of the controller. Further, a careful inspection of the 173 illustrations referred to above will be fruitful of audit and report-preparation ideas which the independent practitioner can put to immediate use.

LEO ROSENBLUM

The School of Business and
Civic Administration
The City College of New York

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BOOK REVIEWS

(Continued from page 453)

Law in its Application to Business (Revised Edition)

By William H. Schrampfer. Rinehart & Company, Inc., New York, N. Y., 1952. Pages: xviii +1093; $7.50.

This is a second edition (the first edition having come out in 1941) of a reasonably standard text in business law. It covers the material usually included in a one-year course in business law and consists, as almost all of them do, of text material and case material. The author has chosen to insert the case material at the end of each chapter rather than putting it at the end of the book.

The book does have review questions and problems for discussion at the end of almost every chapter. The publishers advised that a key to these will soon be available. These should prove a real help to the instructor making use of the book.

It has always seemed to the writer that cases are out of place in a text for undergraduate students although reference to them and excerpts from them would be quite appropriate. The prime function of the case method of study in the law school is to teach the student the technique of case analysis. This is hardly called for in the case of the average business man. A session or two spent in discussion of the function of the cases, of our rule of *Stare Decisis* and of the value (and limitations) of precedent should be quite sufficient. The amount of print and paper and *time* spent in an analysis of these cases could be spent far better in some other direction.

Subject to this one comment (which applies to practically all business law texts) the book is a good one. The type is quite legible and the material is well set out. The author makes his statements with definiteness and without the many qualifications which are always possible.

It might be noted in passing that there exists a considerable need in the law text field which has not been filled by this book nor by any of the others which the writer has come upon, namely, a text in *non*-business law. Such a text would cover decedents' estates, domestic relations, non-commercial torts, non-commercial crimes and other things which are not found in a business law text but which for the lay citizen may be quite as important as that part of our law which applies to business relationships.

Ralph G. Ledley

New York, N. Y.

THE NEW YORK CERTIFIED PUBLIC ACCOUNTANT

EMANUEL SAXE, *Managing Editor*

The matters contained in this publication, unless otherwise stated, are the statements and opinions of the authors of the articles, and are not promulgations by the Society.

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The Investor's Use of the Auditor's Report

By MARVIN CHANDLER

From the investor's viewpoint, complete disclosure, with all significant amounts itemized is the primary requirement of a satisfactory financial report. Equally important is the segregation and explanation of all abnormalities. This paper expands these ideas, among others.

THE title of my talk to you might suggest that I am going to discuss how the investor uses the financial statements prepared by you. The answer of course is that directly he rarely does. He is generally not an expert in interpretation of financial statements and he purchases or sells securities on the advice of others. If he is purchasing a *new* security offering, the investor buys not from the company who is raising the funds but from the investment banker, who is the intermediary in supplying capital to industry. The investment banker in turn buys *his* merchandise—an issue of stock or bonds—from the company that needs the funds—or occasionally from the investor who is selling out—and he sells his merchandise to the investor. His ownership, if he has priced the merchandise attractively, is usually only a matter of days—in fact, sometimes of hours. Before he buys he must make a careful analysis of the merchandise in order to be sure that it is saleable and to enable him to price it attractively. If he has a well-developed sense of ethics, or even if he expects to stay in business very long and retain the goodwill of his customers, like any good merchant—he will stand back of the goods he sells. That means that his job of analyzing the financial affairs of the company must be a continuing one. If the stock of the XYZ Company which the banker sold to his customers declines in price one or ten years later, he must be prepared to explain why, and to suggest on the basis of his studies whether it should be sold out or whether improvement lies ahead. If the stock goes up, some of his customers will ask him whether or not to sell. The investment banker's responsibility is a continuing one.

MARVIN CHANDLER is Vice-President of Reis and Chandler, financial advisers and consultants. He is President of The New York Society of Security Analysts, Inc.

This paper was presented by Mr. Chandler at the regular monthly meeting of the Society, held on April 14, 1952, at the Hotel Roosevelt in New York City.

The Work of the Security Analyst

Now the individual in his organization who makes this analysis before the banker buys the issue and recurrently

thereafter is a security analyst. But the security analyst is not a phenomenon solely of the investment banker's shop. He can be found also in the organization of a broker, where his talents are devoted to scrutiny of outstanding issues as well as new ones offered by the bankers. He is likewise in any large bank, advising on the investment of the bank's funds in securities, in a trust company advising on the investment of funds over which the trust company is trustee, and in an investment counsel firm. He can also be found on the staff of the large institutional investor, the ultimate purchaser of many securities—whether it be insurance company, investment trust, charitable or educational institution. The security analyst is thus standing between the company issuing securities and the investor purchasing them. Our approach is very much the same, regardless of which of the many types of organizations I just mentioned employs us, because our interest in every case is that of the investor.

Now let us see for a moment how our interest contrasts with that of the commercial banker.

First, the commercial banker's function is to furnish to a company working capital ordinarily expected to be repaid in the regular course of business in a matter of months. He is financing a seasonal peak, a single contract, or the requirements of an expanded business until permanent capital can be raised. The investor on the other hand is furnishing permanent capital—funds which will be used to provide basic cash balances, carry minimum receivables and inventories, and build physical plant.

It follows that the analysis of the commercial banker will be from the approach of, "Can I get my money back quickly", a year or two at most, generally. Our approach on the other hand, if the investment is in bonds, will look toward the investor's chances of getting his money back at the maturity date 20 to 40 years hence, and, if in stocks, toward a continuing investment without time limit so long as earnings are satisfactory.

The commercial banker therefore tends to take a liquidation approach. "Will I be paid off if earnings disappear?" The investor takes more of a going-concern view. "Will earnings hold or grow?"

The commercial banker's view is more negative—"What is the worst that can happen to me?" Ours emphasizes more the positive, "What is the best that can happen to me?", although we consider the negative as well. Except in analysis of senior securities, the investor tends to seek a rising return in the future.

Naturally, therefore, the commercial banker is perhaps more interested in the balance sheet than the income account. He is concerned with assets more than earnings. I was interested to find proof of that in the booklet "Financial Statements for Bank Credit Purposes", published by the Robert Morris Associates, a publication with which I am sure that you are all familiar. It devotes almost five pages to a description of what the credit man wants from the balance sheet but only a page and a half to his income statement requirements. The security analyst's primary goal is an estimate of future earnings, and for this task he finds the income account—reflecting past earnings—generally a more helpful guide to the future than the balance sheet.

Another point of difference is that once the loan is paid, the commercial bank's credit analyst has no further responsibility, but that of the security analyst continues as long as the company's securities are outstanding. Even if his employer or customers do not have any investment or other interest in an issue, he may scrutinize it to see if they should.

Now thus far perhaps, I have made our job appear to be the more difficult. However, there are at least a couple of respects in which we would not trade places with the commercial banker. In

the first place, once his loan is made, he is locked in. If he sees a turn of events which alters his previous conclusions, he can't call up his broker and say, "Please sell this loan for me, I've changed my mind." He has to see it through. However, the investor does have the sell-out privilege. He is dealing with a readily marketable product. Secondly, the commercial banker must be prepared to extend credit to any one of tens if not hundreds of thousands of concerns in the most widely varying types of enterprise. The investor, and therefore his representative, the security analyst, is limited to the few thousand American corporations who have securities in public hands. There are 1,300 companies with securities listed on the New York Stock Exchange, another 900 listed on other exchanges, and probably 1,800 of consequence traded in the unlisted market, or a round total of 4,000. This still seems like a formidable number to us, and no one analyst can possibly follow all of them satisfactorily—but it is a far more limited field than that of the commercial banker both in number and variety. We must study the largest and most complex industrial enterprises in the country, but at least we are spared having to know anything about such concerns as the delicatessen store, the export-import firm, the local garage or the auto agency, and dozens of others who frequently knock at the commercial banker's door but rarely if ever have securities in public hands.

That brings me to a final point of contrast. The information furnished to the commercial banker is not for publication or public consumption. It remains in the banker's files and is not available to the company's competitors. Most of the information generally available to the security analyst, however, is in public sources—the annual report and quarterly reports or other interim information furnished to stockholders, Forms 10K and 8K filed with the Stock Exchange and SEC, the registration statement and prospectus if a new offering. Of course the company's investment banker may desire confidential information if he is to underwrite a large new offering. If so, he is certainly entitled to it, and naturally can be trusted with it. Generally, however, we find relatively few instances where information sought by analysts and necessary for them to do a satisfactory job is withheld because to release it would not be for the best interests of the security holders.

Accounting Data Needed by the Security Analyst

Now I would like to try to be a little more specific as to the type of data the security analyst finds necessary and the method of presenting it which is most useful to him. If I were ordered to sum up our need as briefly as possible, I would use just two words —"full disclosure." If you give us all the facts—if the financial statements as presented to us are designed to reveal rather than conceal—we will have no just cause for complaint.

Before getting into the details of the financial statements, I should make it clear that the security analyst realizes that the accountant usually is not responsible for the method of presentation of financial statements nor the omissions and other points of criticisms which will follow. We talk with executives of many corporations and attempt to pursuade them to adopt our ideas in regard to financial statements, and we know from acquaintances in the accounting field that the accountants also have been pursuing a long campaign for accurate, understandable presentation. My comments, therefore, in regard to financial statements, although presented in an abstract way, are not criticisms of practices of accountants. If they have any value it may be adding ammunition to the arguments of accountants in their efforts to pursuade corporations to improve statements for the ultimate benefit of the investor.

Balance Sheet

From the balance sheet we expect a picture of the financial position of the company. We must be able to judge if it is adequately capitalized and if it has sufficient cash and working capital for its needs, and be able to measure the asset protection for senior securities and the net worth or book value applicable to the common stock. For this purpose, we do not require a detailed segregation of receivables by age, selling terms, itemization of largest accounts, and the like, such as our friends, the credit men, require. With respect to inventory, it is helpful to us to have a breakdown by stage of manufacture or type of goods. United States Steel Corporation is a good example of a company which presents an excellent classification of its inventory account in its annual report to stockholders. We also expect, of course, to have a complete statement as to the method of valuing inventory. If some other basis than lower of cost or market is used, such as LIFO or base stock, in order to appraise properly both the inventory on the balance sheet and the income statement in comparison with those of other similar companies not using the same method, we need to be told the date when this method was adopted. Of considerable usefulness, but perhaps not practical, would be a statement of the approximate market value of the inventory if valued on some other basis. Some companies have adopted a LIFO or base stock method for part of their inventory and so state, but unless we are informed as to approximately what proportion of inventory this represents, the statement is not very helpful. We like to see in a long form certificate the extent to which the inventory was verified and, perhaps, whether or not it was checked to see if it represented in part obsolete or non-saleable items.

I would say, as a general rule, that fixed assets are adequately reported for our purposes by most companies. We are interested in the composition of fixed assets in terms of land, buildings, machinery and equipment, and the like, with related depreciation accumulations, and in the basis of valuation. If any assets have been fully depreciated, perhaps by accelerated amortization in World War II, but are still in active use this should be spelled out. If any recent appraisals of the assets have been made, this information is helpful, as would be the amount of insurance carried on them.

Investment accounts on the balance sheet are often given a meager description. We believe that the owners of the business — the stockholders — are entitled to know specifically what the major investments are—at cost and market, if any.

On the liability side, one item in current liabilities which is frequently a mystery is the accrued taxes account. For our purposes a segregation of accrued federal taxes on income from other taxes is a vital necessity. With federal taxes playing the important part they do in earnings today, we require a full understanding of everything connected therewith if we are to judge the impact of various developments on the company we are analyzing. The accrued federal income tax liability should correspond to the amount accrued in the income statement for this purpose during the year, except for matters pertaining to prior years. But you and I know that companies often accrue on the basis least favorable to them but file their return on the most favorable basis, thus in course of time building up in the liability account a reserve for past years' taxes. We would like an explanation of this, a note explaining what the major elements in the liability account relate to if more than the current year's accrual, and the extent to which past returns have been audited and cleared. We want to try to form an opinion, tentative though it may be, of the extent to which surplus may ultimately be enhanced if the company is successful in its dealings with the

government. We also expect that once the return has been audited and the matter settled, any unused portion of the liability will be *promptly* transferred to surplus, preferably directly or in any event through income. Of course it goes without saying that if the Government is asserting claims for which an inadequate accrual has been made, the auditors should point this out.

Treatment of debt due within one year, such as sinking funds and serial obligations, is not uniform but it is not material to us whether stated as a footnote to the long-term debt or carried in current liabilities, as long as the facts are disclosed.

With respect to capital stock accounts, we believe that the terms of any stock options should be fully disclosed. We also think that companies with convertible securities outstanding should state the conversion terms right in the annual report, either in the balance sheet or by footnote thereto, and it is most helpful if the number of common shares into which the security is then convertible is stated.

Many companies have contingency reserves, reserves for inventory losses and the like. These are a matter of concern to us. We need to know when they are created or added to, where the charge was made, what the purpose is, when they are drawn upon, and what is then credited. In measuring the net worth of the enterprise, we must know whether such reserves are earmarked against a specific, real and tangible potential liability, or whether they are merely a segregation of surplus without specific purpose. You can easily see how in comparing two companies, we could be misled if one had set up a reserve against no visible contingency, the other had not, but we compared the book values of the two stocks without including the contingency reserve as part of the net worth of the former. Similarly it is preferable to us to have working capital "reserves" deducted from the asset accounts to which they apply, rather than lumped under general reserves.

Any contingent liabilities, of course, should be stated. One we frequently encounter nowadays is the liability for past service benefits in connection with pension plans. We are interested in the amount thereof and the treatment both book-and tax-wise. Some companies have had pension plans for a sufficiently long time so that the day when earnings will be relieved of the amortization of past service liability is not too far distant. This could have a significant favorable effect on earnings, and we would like to know it.

Income Statement

That takes us to the income account. The analysts' interest here is primarily to use the past as a guide to the future —as a basis for judging the effect of various possible developments. For this purpose the first need is a *complete* statement, with sales, cost of goods sold, selling, general and administrative expenses, depreciation, and each major form of taxes spelled out. If for any specific company there are any major elements of expense which do not fall in this category, such as rents in a chain store enterprise, they should be revealed. Some companies have adopted the practice, either in the income statement or elsewhere in their annual report, of telling how much was charged to income of the year for salaries and wages, how much for materials, and the like. This is exceedingly useful to know. A glance at the United States Steel report permits an estimate of the effect of a 10% rise in payroll expense, for example—not an accurate figure, to be sure, but a much better basis for advising investors of the impact of wage rises than picking a number out of the air or gazing at a crystal ball.

In presenting sales and expenses, any breakdowns thereof by major divisions of the business is extremely helpful but rarely proffered. Some companies give some assistance by giving

approximate percentages of the sales of major products or divisions in the text of the report. A few have segregated sales not by product but by the market or ultimate purchaser. Borg-Warner, for example, commendably reports the division of its sales among the various industries served, namely, automotive, household appliances, agricultural, aviation, etc.

I would now like to jump down the income account to the item of income taxes because, as I indicated before, at present tax rates, a full understanding of what goes into the determination of this figure and of differences between tax return and earnings reported to stockholders is an absolute necessity if the analyst is to fulfill his function of weighing the securities of one company against others and judging the effect on earnings of various possible developments as they may occur in the future or as they actually occur.

The first question any analyst asks about a company today is, "What is its excess profits tax status?" If the company is paying excess profits tax, we need to know how much. This permits us to judge, if earnings slide off, how far down they can go before the decline in pre-tax earnings ceases to be cushioned by the excess profits tax and becomes cushioned only by the much lower 52% normal and surtax. Likewise, the amount of excess profits tax accrued permits a judgment of whether retained earnings or any new capital injected into the enterprise subsequently will take the company out of the EPT bracket. It would seem obvious that security analysts would need to have the excess profits tax accrual segregated from the regular tax accrual, but the extent to which companies fail to show this is distressing. Of course, of most usefulness is a statement of the amount of the excess profits tax credit and option used, but we are not hopeful of having that information divulged, even though we may see little reason why it shouldn't be. Another necessity in reporting the tax accrual is a segregation of the accrual applicable to the current year's earnings from the assessments or refunds pertaining to prior years. The latter should be shown separately and explained.

This leads me right into the analysts' second requirement in the income account as reported to investors. You will recall that I said the first need was for a complete statement with all significant amounts itemized. The second requirement is for a statement which segregates and explains fully all abnormalities. The usefulness of the statement to us diminishes to the extent that it is beclouded with unusual, extraordinary, non-recurring, or prior-year items. It is very important to us, therefore, that any significant influences on the income account other than the normal operations of the business be clearly described and segregated so that the analyst can restate the income account without them. By any influence, I mean just that. For example, it is not helpful to us to have an unusual item of income or expense segregated without any indication of the extent to which it affected the tax accrual for the year. Many extraordinary items such as capital gains or losses are not subject to a simple 52% tax rate, but it seems to be a habit of many companies whose securities we analyze to spell out the before-tax amount of other income or expense but not the net effect. In the public utility field, for example, many companies in recent years have realized handsome profits from the sale of appliances, which is significant analytically because it is not subject to regulation by the state Public Service Commission and it is also often likely to be only a temporary source of sizeable earnings. Most companies show this profit in non-operating income as "Net from Appliance Sales," but do not tell us whether it is net after a prorata share of income taxes or before. A check-up shows that nine times out of ten it is net before taxes so that the

profit from this activity is really overstated. A simple modification to read "Net from Appliance Sales, Before Income Taxes" would solve the problem for us.

We see all kinds of items run through income which have no relation to the normal operation of the business and generally influence the tax accrual significantly, but with no explanation of the effect thereon. Sometimes debits or credits are made to surplus but the tax effect thereof results in lowering or raising the income tax for the year. All we ask again is a full disclosure. As a matter of fact, we would be happier if all extraorinary items, items relating to prior years and the like which render it more difficult to the analyst to understand the income statement and use it as a tool in peering into the future were charged or credited directly to non-operating income or to the surplus account, together with the related income tax or credit. That tends to differ from current policies of the Securities and Exchange Commission, however, and we recognize that what is best for us may not necessarily be good accounting. But if we are given all the facts, we are perfectly willing to rearrange the income statement to suit our needs.

Other Reporting Problems

Another example of the type of reporting that renders our work more difficult occurs in the case of lack of uniform treatment of subsidiary companies. Sometimes it is not clear from the report whether all subsidiaries are or are not consolidated. Often there is a different treatment on the tax return than in annual reports to stockholders. We would like to know specifically which subsidiaries' accounts are consolidated and which are not, both per books and per tax return. Let me give you a simple example of how this can be deceiving. One large company I know of has a wholly-owned subsidiary which it regularly has not consolidated in its report to stockholders. The subsidiary has earned money and occasionally paid a dividend in the past. Last year, however, it lost over $4,000,000. The parent filed a consolidated tax return, thereby reducing its own income tax liability by $2,000,000. But its own income statement carries no indication or footnote to that effect. If the subsidiary breaks even this year, which is a reasonable expectation, the parent will have to pick up $4,000,000 of income from its own operations before income taxes if it is to equal last year's results. In the case of foreign subsidiaries which pay an income tax in a foreign country for which credit is taken on the consolidated United States tax return, distortions of the tax accrual and misunderstanding or confusion by the analyst are likely unless a full explanation is given.

Of course, for any subsidiaries not consolidated on the books, a full statement of the parent's equity in earnings is a requisite. But this equity will be affected by the amount of dividends declared by the subsidiary. Since dividends are in effect taxable at approximately a 7½% rate, the equity in earnings will be greater if no dividends have been paid than if all the earnings have been paid up in dividends. Therefore, both the equity in earnings and the dividends received should be stated. Most helpful of all is to have both balance sheet and profit and loss account of any significant non-consolidated subsidiaries included in the report, and if consolidation or failure to consolidate has an important effect on the published income statement, clear explanation should be given.

We of course like to know the depreciation method and rates used per books and whether the same charge is made on tax returns. For concerns in a wasting asset business, such as oil production or mining, an explanation of depletion accounting for book and tax purposes is definitely a necessity. In fact oil company accounting varies so much among different companies, and is such a mystery to many less-experienced analysts that a full description of the methods used would be widely appreciated.

Another element of interest to us at this time is the status with respect to certificates for accelerated amortization of emergency facilities. We believe that we should be told the amounts of any certificates which have been granted by the DPA, of any such applications pending or planned, and of the actual or intended book treatment of this depreciation and actual or intended treatment of the accompanying income tax saving as soon as a decision thereon is reached.

Also of contemporary interest is the matter of renegotiation. To weigh the year's earnings properly, a statement should be appended indicating whether any sales are subject to renegotiation and, if so, the amounts involved.

Now I would like to dwell briefly on a few miscellaneous subjects which in all cases may not fall directly under the category of auditor's report but where perhaps you can be helpful to us none the less.

First, may I urge that reports include, in addition to the current year's accounts, a comparative statement for the preceding year. This is now pretty general practice with respect to income accounts but lamentably infrequent with balance sheets and surplus reconciliation statements, although no less useful.

Secondly, may I urge that quarterly or other interim financial statements be prepared in the same manner as annual statements. I realize that often these are unaudited and outside your scope, but we are frequently confronted with a statement for the year that bears no relation to the results for the nine months. The first three quarters may look fine, conditions may be propitious in the final quarter, but year-end adjustments result in the year's profit falling below that of the first nine months. Any help you can render in correcting this sort of result will certainly be appreciated.

Thirdly, may I express the analyst's distaste for the over-simplified statement—of the "What We Owe—What We Own" school. I am convinced that stockholders as a rule still won't bother to read it or be able to understand it if they do. If it must be put in, put it up in the front of the report and give us a set of complete statements in the back.

Fourth, may I stress that this criticism does not hold for the "Where Got—Where Gone" statement (Source and Disposition of Funds). These are most useful in tracing the flow of cash, and we wish that we had more of them.

Fifth, a necessary accompaniment to the financial statements are operating statistics—unit production and sales data, etc. We hope that you encourage their presentation to us, although also outside your scope.

In closing, may I say that I am afraid I may have sounded unduly critical. I hope that the criticism is viewed as constructive, not carping. We realize that there are inevitably some conflicts between what we want and what it is to the best interest of the shareholders to publish. We further recognize that there are a vast number of annual reports to which my comments do not apply at all. Over the last several years there has been a tremendous and rapid advance in the presentation of financial information to the analyst and investor. For your assistance in this advance in the past and for your anticipated cooperation in the future may I express our thanks.

A Banker Looks at an Audit Report

By ARTHUR L. NASH

The author of this paper, a banker, points out some of the shortcomings of financial reporting encountered by him and his colleagues, and makes these specific suggestions for improvement.

IT has not been so many years since the majority of the statements presented to the banks for credit purposes were unaudited. Within the last quarter century the banks have steadily brought pressure to bear on borrowers to have at least an annual audit by an independent C.P.A. I daresay that today only a nominal percent of loans (I cannot think of a single case in my bank) are made without such an audit.

This is a major trend and has led to additional business for the accounting profession as well as to a sounder basis for the extension of credit by the banker. While my comments tonight may be construed by some as critical, they are intended to be constructive and, in fact, are an argument for additional business for you.

The bank credit fraternity, with the valued assistance of the accounting profession, has recently published a small pamphlet entitled, "Financial Statements for Bank Credit Purposes." This has been circulated to 14,000 banks throughout the country, to 19,000 members of the American Institute of Accountants, and to all members of your Society. It is intended as an aid to the accountant as well as the borrower and, if all the audits included the information which is recommended, the credit analyst's job would be immeasurably simplified and your gross earnings substantially increased. If you have not read a copy, please do so and keep a supply on hand to show to recalcitrant clients who say, "The bank doesn't need to know that", when you wish to extend your examination to include what you believe is essential to a proper knowledge of the company's position.

In preparing my talk for this evening, I canvassed a number of my fellow credit officers as to what they considered to be the most important message which I could carry to you. Almost without exception, they replied, "Talk about the certificate and particularly Statement #23." I quite agree with this consensus and, with a few exceptions, my remarks will dwell on those points.

If I may be permitted to paraphrase a well-known quotation, I would like to say: "Oh, certification! How many crimes are committed in thy name!"

Sincerely, this question of the auditor's certificate is probably the most difficult element to appraise in the credit analyst's program. It is the grave of many a young chap who failed to recognize its significance. It is a cardinal principal that a credit analyst shall read the certificate even before looking at the balance sheet. It used to be the practice, when I was analyzing statements twenty years ago, to compare the current year's certificate with that of the previous year to detect changes in phraseology. I believe there has been

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improvement, or should I say simplification, in wording, in that hedge phrases and nuances have been substantially eliminated. I wondered, many times, in those days, how much the accounting firms may have paid for dictionaries or encyclopedias to get shades of meaning for the phraseology in their certificates.

Despite the continued efforts of the American Institute of Accountants and the various state Societies to improve the practices of certification, we, who review the audit reports, have almost reached the conclusion that there is still a long tortuous road ahead to the "promised land."

Statement #23, promulgated in revised form in December 1949, by the American Institute is considered by many to be the most constructive forward step in accounting practice in many years. When I see the audit reports come across my desk, I (and I know, others) frequently wonder how many accounting firms are aware of this statement and, if so, what it implies.

Some Case Studies of Problem Situations

We bankers are sure that, if the accounting profession as a whole understood the reactions of the informed reader of an audit report to the type of certificate or lack of certificate over an auditor's signature, or on his stationery, there would be an immediate change for the better.

While I do not wish to burden you. I believe you will be interested in actual comments received in my canvass of fellow credit officers:

> "Many reports provide a large amount of factual material from the company's books with no verifications and few comments.
>
> "Teamwork between the accountant and the banker, in aiding their customer through a greater understanding of the figures, would be beneficial."
>
> "Many of the acocuntants' reports are such as could be prepared by a company's internal bookkeeper. This is not a good trend for banks, for borrowers, or for accountants."
>
> "The accountants would seem to have nothing to lose by insisting on spelling out clearly that the scope of their assignment was limited and, therefore, they can give no unqualified opinion."

These are all quotations from letters from my fellow bankers. We fully sympathize with the auditor's problem with his client and, perhaps, it is a matter of continued education of both accountants, bankers, and borrowers which will eventually produce the desired end.

Put yourselves in the position of a bank which is being asked to lend $100,000 where one of its bases or tools for decision is an audit report which includes the following certificate:

> "We have audited the books of accounts and records of A B C Co. for the year ended December 31, 1951, and hand you herewith our report thereon.
>
> (Signed) C. P. A."

Examination of the balance sheet and other data showed no indication of inventory valuation, no evidence of more than a routine presentation of facts which could have just as easily been prepared by a bookkeeper. Here we have a respectable auditor—we know that—but how much faith can be placed in these figures as presented? Assume that the moral element of management was only fair—what would you do?

And how about this case? The auditor's letter of transmittal indicated verification of cash balances, complete check of receivables without verification, and he says

> "We are satisfied that accounts receivable are correctly stated."

However, they were only $2,000 in total current assets of $400,000. Now for the meat in the coconut. This is what he says about inventory!

> "There were submitted to us schedules of merchandise inventory on hand as at December 31, 1951. We solicited confirmations from public warehouses in which the goods were stored and in this manner determined that the quantities were correct. We discussed prices with your firms' management and compared them with suppliers' invoices. We determined that goods were priced at cost. There was not taken into account decline in market value."

The opinion is as follows:

> "In our opinion, the statements submitted herewith set forth substantially the net worth of .... Company as at December 31, 1951 and results from operations for the fiscal year then ended, based on our examination of your books and records which were maintained in conformity with generally accepted accounting principles applied on a basis consistent with prior years, except that the value of inventory is reflected herein at cost whereas in prior periods inventory was stated at cost or market, whichever was lower."

Inventories totaled $210,000 out of current assets of $400,000, and working capital of $250,000.

How is the credit grantor to evaluate the working capital, net worth, and profit elements of this report in the face of such a statement? How much did inventory decline? 10%? 50%? How can the auditor properly establish cost of goods and net profits knowing that the figure of inventory is over-valued? Does not the exception invalidate the opinion? To be sure, the credit grantor, having the full audit report, is on notice; but how about those who only see the balance sheet in Dun & Bradstreet? Has the auditor done his full duty to those who may use the balance sheet and profit and loss account for credit purposes? What do you think?

Another interesting situation which occurred recently was the receipt of an audit report in which the auditor did not give the scope of the audit and expressed an opinion qualified only as to an exception. This exception, however, involved an amount of $370,000 representing what the auditor considered to be a potential liability of the subject of the audit for debts of another company in which the President was the controlling factor, although there were no inter-company guaranties of any kind. The subject of the audit had a net worth of only $200,000, and an even smaller working capital. The auditor did not explain the full reasons for his exception. It certainly seems to me that an exception of this size related to the company's net worth is of such character as to negative substantially the opinion; and it would seem reasonable that the auditor should have included a detailed description of the scope of his audit and the reasons for his exceptions.

It developed, in conversations with the borrower, and later, with the accountant, that he had actually done a complete audit including attendance at inventory-taking and even an independent check on inventory values by outside investigation. If he did all this, why not say so? It would have prevented an instantaneous unfavorable reaction, embarrassment, and saved time for all.

This matter of reaction and first impression is more important than the mere words would imply. When a credit analyst has a "feeling" that there may be something hidden in the situation, he stops at nothing to try to uncover it. Frequently, this involves much time and energy, both for the analyst and for the bank officer and borrower, and possibly even the auditor, in discussing the figures at a subsequent conference. Had the auditor made his position clear and, as far as possible, stated the facts in terminology incapable of double meaning, much valuable time would have been saved.

Admittedly, these cases have been selected for the purposes of my talk and they are certainly the exception rather than the rule. On the other hand, from comments made by my banking associates, it seems evident that there are a sufficient number of these in every bank to warrant careful study by the accounting profession. This will be emphasized even further in some remarks which I shall make later based on a survey recently completed by the American Institute of Accountants.

We feel that Statement #23, if followed closely by the auditing profession, would eliminate much of the time consumed by the banker, borrower and accountant in determining just what was done and what was not done.

I have just mentioned terminology.

One of my fellow bankers objects to the issuance of condensed balance sheets for any purpose. For example, I recently saw a balance sheet which lumped the following in one item: "Taxes and accounts payable." No profit and loss account was submitted, and the item was rather substantial. Having in mind that 70% of 1951 taxes are payable in the first six months of 1952, how is the credit grantor to estimate the probable pressure on working capital within the next six months to meet this unknown tax liability? We can go to the borrower and get this information, and do; but part of our job is to try to anticipate our borrower's requirements in order to be prepared to discuss his affairs intelligently. In other cases, we have raw, finished and in-process inventories lumped as one, or, in the case of a commodity concern, one inventory figure without comment as to the proportion in various commodities even though some rank large in the total and are volatile in price characteristics. This last is of prime interest in times of declining commodity price levels.

The auditing profession can reply and does, "What about the expense of this additional work? We can only do what we are paid for!" Agreed—but if we cooperate and, if the auditor will show the client, on the one hand, the requirements for an unqualified certificate *and* on the other the Robert Morris booklet, and will bear in mind particularly the credit grantor's reaction to an inadequate certificate and unclear terminology, we may be able to sell the borrower on the idea of spending a little more money for a better job.

After all, we are both "doctors" in a sense. We should both do our utmost to advise our mutual clients to the end that they may operate successfully and with the maximum of efficiency. So many of the smaller concerns are directed by men of practical experience, with only the most casual knowledge of the technicalities of accounting or finance, so the accountant and the banker have a large field for wise counsel.

With steadily increasing costs of operations, prudent financial management should continuously look to the aid obtained from budgets and cash forecasts. The accountant can give invaluable aid in preparation of these elements and cooperate with the banker in educating the businessman in their use.

While on the subject of educating management of small companies, we should not forget the directors. There are undoubtedly hundreds of closely-held companies originally set up years ago and now controlled by second or third generation legatees, many, women. These stock holdings, in many cases, are now individually small and, hence, management tends to perpetuate itself with the larger stock interests represented on the Board of Directors by relatives. In many cases, these directors do not realize their full legal responsibilities and, because of their status as family representatives, may not necessarily be qualified advisers to management.

I know of one such board which had a rude shock at the inception of Statement #23 when the auditor said in the fiscal audit:

> "In accordance with instructions, we have omitted certain auditing procedures which are required for the expression of an opinion as to the financial statements; therefore, are not in a position to express an opinion as to the statements presented."

The immediate question raised was, "Who gave such instructions and why?" and, second, "What procedures were omitted?"

The answer to the latter was, of course, simple, namely, no confirmation of receivables or payables and no independent check on inventories. On investigation, it developed that the instructions came from the president because he thought the expense was unwarranted.

While the directors had no reason to believe that there was anything wrong, the point was made that the very pur-

pose of having an independent check on management was lost both to the directors and to the management itself. Steps were taken to arrange for an unqualified audit in future years, and the very first year turned up a sizable difference in the inventory and also in cost figures which, again, called for further investigation and the institution of adequate controls and records. All additional business for the auditor and of prime value to the management!

Suggestions for Improvement

My discussion thus far has been largely in generalities. Before closing there are a few specific improvements which banks have suggested should properly be instituted and, with your permission and with the understanding that the background of each cannot be fully explored in this talk, I pass them on to you.

Net unsold inventory position: There are many trading businesses where the client buys and sells a commodity without further processing. Today, with falling prices in commodity markets, it is essential that a proper audit report include information as to future commitments and even a summary of the net inventory position. These details have a vital bearing on the over-all position, and to leave out information regarding commitments to purchase of a substantial nature (and I have seen some cases where they approximate or exceed inventory on hand) is misleading. Generally in these trading businesses, particularly those involving commodities with volatile price characteristics, a banker likes to see any speculative position carried within the company's own working capital and not on creditors' money and, hence, has a vital interest in the net position.

Contingent liabilities: It is frequently observed that the auditors fail to comment on contingent liabilities, such as unused commercial letters of credit, future commitments, guaranties, and other such items. Bankers generally believe that these are a proper part of any audit. Particularly today is the unamortized portion of pension fund payments an important consideration in many businesses.

Ageing of receivables: It is felt that, where an ageing of receivables is made (and it is desirable in most instances), it would be helpful if the auditor also commented on the terms of sale and on any unusual concentration of risk. In other words, where receivables rank large as a current asset, it would be reasonable to indicate that the preponderance of receivables of $X was due from "so and so" number of debtors or to list the ten largest.

It would seem to me that any management, as well as the banker, would value independent comment on any of these three points and it would certainly lead to an early discovery of an unhealthful trend.

One point which looms large in the minds of some bankers lies in the disclosure of the estimated income tax liability of partners in a partnership. This is essential where the payment of such taxes can only come from the working capital of the partnership. Admittedly, this may be a difficult nut to crack, but I'm sure the effects of such liabilities on a business in a declining economic cycle is obvious.

Recent Survey of Audit Reports

I have referred previously to a survey made by the American Institute of Accountants on the adherence of the auditing profession Statement #23. Before I close, I think you will be interested in a few highlights from this survey. In 1949, Harry M. Prevo, in Detroit, made a survey having to do with the number of auditors observing inventories, confirming receivables and the certificates relating thereto. Recently, the American Institute approached the Robert Morris Committee on Cooperation with CPAs and arranged to have a sampling with five New York banks involving some 110 reports. These were taken at ran-

(Continued on page 474)

Developments In Financial Reporting

By John Peoples, C.P.A.

This article points up some of the developments in financial reporting which have taken place in the past 25 years, under three broad headings: Extent of disclosure; changes in accounting concepts underlying the financial statements; and making the statements readily understandable.

In recent years there has been an increasing interest shown by stockholders in the affairs of their companies and management has done much to supply pertinent information in the annual reports.

This article will attempt to point up some of the developments in financial reporting which have taken place in the past 25 years. The discussion is arranged under three broad headings:

1. Extent of disclosure
2. Changes in accounting concepts underlying the financial statements
3. Making the statements readily understandable

Extent of Disclosure

In the case of a company listed on the New York Stock Exchange, the original listing application includes financial statements and the company agrees that subsequent reports to stockholders will not contain any less information. This, however, was not always the case.

Almost a century ago, the New York Stock Exchange, struck by the dearth of investment information on the actively traded securities of the day, appointed a special committee to remedy the situation. That this committee met with scant success in its search for the facts is witnessed by the following correspondence with the Secretary of one of the country's largest railroads—a "market leader" of its time:

New York
19 Broad Street, Room 17
22nd March, 1866

"To the Secretary of the
....................Railroad
Sir:

"The Stock Exchange of New York desire to collect Reports and Documents connected with Finance and Rail-Roads, and to this end have appointed a committee.

"I therefore beg you to request you will direct, that from time to time, as they may be issued, the Reports of your Company be sent to the Secretary of the New York Stock Exchange, and if not occasioning too much trouble, you will greatly oblige by furnishing also, the Reports and statements from a period as far back as they have been preserved.

"P.S. Answer will oblige."

The answer, written in longhand on the back of the request for information did not waste many words. It read:

"This company makes no Reports and publishes no statements—and has not done anything of the kind for the last five years."

On the whole, however, many companies in this country have for years supplied detailed financial information long before there was any compulsion from outside authority. General Electric Company has been issuing comprehensive reports since its formation in 1893 and the same is true of United States Steel Corporation since it was incorporated in 1901.

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This paper was presented by him at a meeting of the Memphis, Tenn., chaper of the N.A.C.A., held late last year.

Good financial reporting is not, however, confined to listed companies though there are still more than a few where the directors seem to feel that the stockholders are entitled to little in the way of information. For this reason, the Securities and Exchange Commission has been seeking to extend its jurisdiction over all companies with assets of $3,000,000 and having over 300 stockholders. Of the estimated total of 3,090 companies in this group approximately two-thirds are either already registered with the SEC, or file with other governmental agencies public reports, which are comparable in their basic aspects with those required by the Commission.

With respect to the 1,000 companies in this category not reporting to any governmental agency 70 were selected at random by the SEC and their reports to stockholders were scrutinized for adequate financial disclosure. While some may contend that the SEC was not exactly impartial in endeavoring to establish its case, valid criticism was made of some of the reports in the following respects:

Inadequate Reporting Cited by the SEC

1. 13% gave no income statement at all and a further 34% failed to disclose volume of sales or cost of goods sold. A number of companies began with a "net income" figure after all deductions save one or two, such as taxation and depreciation. In all, approximately half the reports examined either contained no income statement or contained a highly condensed statement that could be of very limited value to an investor.

2. 20% did not furnish an analysis of surplus. A company not supplying such a statement can, and sometimes does, conceal gains or losses of the greatest significance. By withholding such a statement a company can report current earnings year after year in its profit and loss statement while concealing the fact that substantial losses of an undisclosed nature are being charged directly to surplus.

3. In more than 26% of the balance sheets the description of the capital stock was inadequate. In many cases it was impossible to compute the book value or such a basic figure as the earnings per share.

4. Other weaknesses were failure to describe basis of valuing inventories and fixed assets, complete absence of explanatory footnotes or at best inadequate information, and failure to disclose the amounts of reserves and, in many cases, their purpose.

In addition, it is believed that a substantial number of companies with assets of $3,000,000 and 300 stockholders issue no reports whatever. It has also been suggested that the companies which do issue reports, despite their weaknesses, constitute an above standard sample of the financial reporting practices of unregistered companies. It is doubtful, however, if such a conclusion can be reached on a relatively small sample. An analysis made in our own office of the reports of 177 unlisted companies showed that only 17% did not report their sales.

Minimum Requirements for Reporting

However, despite the generally high level of published accounts, this review by the SEC shows that there is still room for improvement in the financial reporting of many companies. The lack of information is not due in most cases to the ignorance of the accounting officers, but rather to a deliberate policy of telling the stockholders as little as possible. The investor is entitled to know how his investment is faring and to be given enough information to tell if management is performing a satisfactory job. To come to a decision, the annual report should contain the following:

1. A balance sheet which would show the assets and liabilities in some detail. There should be a breakdown of inventories where this is practicable

and the amount is significant. The purpose of all reserves should be indicated and any charges or credits to general reserves, if material should be disclosed.

2. An income statement which would show the sales volume and details of depreciation and other large non-cash type of expenses, non-operating charges and credits, income taxes and net income for the year.

3. An analysis of surplus either as a separate statement or as part of the balance sheet.

4. An auditors' report.

Changes in Accounting Concepts

Perhaps the most significant trend in the past 25 years has been the growing emphasis placed on the income account.

At the International Congress of Accountants in 1904 in a paper by Dickinson on "The Profits of a Corporation," he said:

> "If the balance sheets at the beginning and end of a period are theoretically and practically accurate and show the true financial position at those dates, the increase or decrease of the surplus after allowing for distribution of profit during the interval, represents the time profit or loss for the period."

Brundage, in the Dickinson Lectures before the Harvard Graduate School of Business Administration in 1951, commenting on this states:

> "This was the point of view in accounting circles generally. The emphasis placed on the balance sheet and the conception of income as the difference between balance sheets, was, I think, partly derived from single entry bookkeeping in which profits were not determined until stock was taken and the balance sheet prepared."

This viewpoint had changed by the time the Committee on Accounting Procedure of the American Institute of Accountants issued its first bulletin in 1939. In that bulletin the Committee referring to the increased recognition of the significance of the income statement noted "a tendency to regard the balance sheet as the connecting link between successive income statements." In other words, what was the connecting link in Dickinson's time had now become the significant statement, such importance being explained by the fact that the value of a business is dependent mainly on its earning capacity.

With increased emphasis on the income statement there has been a corresponding effort to "sharpen" the conception of what is income for the year and there are now two schools of thought on this subject.

The "all-inclusive" group insist that annual income statements taken for the life of an enterprise should, when added together, represent total net income. They emphasize the dangers of possible manipulation of annual earnings if material extraordinary items may be omitted in the determination of income. They also assert that, over a period of years, charges resulting from extraordinary events tend to exceed the credits, and their omission has the effect of indicating a greater earning performance than the corporation actually has exhibited.

On the other hand, those who advocate the current "operating performance" type of statement generally do so because they are mindful of the particular business significance which a substantial number of the users of financial reports attach to the income statement. They point out that, while some users of financial reports are able to analyze a statement and eliminate from it those unusual and extraordinary items that tend to distort it for their purposes, many users are not trained to do so. The Committee on Accounting Procedure of the American Institute of Accountants is with this second group. It is the opinion of this Committee "that there should be a general presumption that all items of profit and loss recognized during the period are to be used in determining the figure reported as net income. *The only possible exception to this presumption in any case would be with respect to items which in the aggregate are materially significant in relation to the company's net*

income and are clearly not identified with or do not result from the usual or typical business operations of the period.

There would probably not be much difference between the two schools of thought if there was reasonable agreement between all members of the "current performance" group as to meaning of "materially significant." Of 525 company statements studied by the American Institute last year, 365 had no surplus charges or credits. Of the remaining 160 companies, the surplus charges or credits were less than 10% of the average net income for the current or preceding year in 100 cases. It is doubtful if a charge or a credit amounting to less than 10% of the net income can be considered as "materially significant."

With the growing importance of the income figure there has been an increasing conservatism in the methods of computing income. Some of these changes will be considered in the following paragraphs.

Depreciation on Appreciation

The first edition of the Accountant's Handbook, published in 1923, explains that when assets are written up, depreciation written off should be separated into two parts, the part applicable to original cost being a charge to income, and the part applicable to appreciation in value being a charge against surplus set up at the time of asset revaluation. Under this method a company could claim on one hand a high value for its plant and equipment with a consequent increase in the book value of its shares but with no penalty against earnings because of increased depreciation.

This is no longer considered good accounting practice and, back in 1940, the American Institute of Accountants suggested that:

"When a company has made representations in its balance sheet as to an increased value of its property, it is not unreasonable to interpret the formal adoption of the larger amount for plant as implying an intention on the part of the company to maintain that larger amount of invested capital intact by proper charges against income. To implement such intention it is necessary that the company charge income with depreciation on the larger values represented."

Stock Options

This has long been a way to encourage key executives to put forth their best efforts to increase a company's profits. In the early days of such options the usual accounting treatment was to credit the amount paid for the stock to capital account, with no further concern as to the possibility of a charge to income.

From the key executive's position this may have been a satisfactory arrangement as profits were not diminished and the stockholders were probably not aware of the over-all high compensation the executive was receiving. The stockholders were, of course, in some cases suffering a substantial but unnoticed loss through the dilution of their holdings.

Today sound accounting practice requires that the difference between the option price and the fair value of the stock at the date the option right becomes the property of the grantee be considered as part of the cost of the services of the key employee. As such, this difference will be charged to income.*

Pensions

While the granting of funded pensions has been comparatively rare until the Second World War years, in the early days of these pensions the cost of the past service benefit was considered by some accountants as a proper charge against surplus. In most cases, however, such plans were entered into for

* An increasing number of accountants feel that the date when the option is granted is the correct one for measuring the difference between the option price and the fair value. The Committee on Accounting Procedure of the American Institute of Accountants is at present considering this question.

the purpose of obtaining the services of employees for the future even though those immediately benefiting were on the verge of retirement at the time. This indicates that the charge, even though based on past services, should properly be spread over the current and future periods, and not charged to surplus. The American Institute of Accountants, in Research Bulletin 36 issued in November, 1948, has taken this position and it is now generally accepted practice.

Lifo Method of Valuing Inventory

Neither the first edition of the Accountant's Handbook published in 1923, nor the second edition published in 1933, makes any reference to the Lifo method of valuing inventories. In the first edition there is a brief paragraph on the "base stock" basis which states that it is subject to criticism for the reason that balance sheets based on such valuations are misleading. In the second edition several pages are given to describing this method. It was not, however, until 1939 when Lifo became an acceptable basis for inventory valuation for Federal income tax purposes, that any real impetus was given to this method of valuation. The base stock method cannot be used for tax purposes.

Either of these methods has the practical effect of matching current sales with current costs and thus eliminating from the income statement, to a subtantial degree, the effects of price inflation.

The same cannot be said for the first-in-first-out method. Increases in inventory unit prices during the year have found their way into profits and without separate identification. However much we may argue whether these increases represent real profits or not, there is no doubt that they are of a non-recurring or extraordinary nature. They do not belong in any figure used to judge earning power. The stock market has discounted such monetary profits but it has had to do it without being able to do much more than guess at the amount involved.

Stock Dividends

While not a matter of income determination and possibly not even a matter of accounting principles, the change in thinking on stock dividends is another example of the trend away from the "eating your cake and still having it" concept of earlier in the century.

Today, it is recognized that a stock dividend should be measured by the fair value of the stock issued as a dividend. The determination of fair value is a matter for the directors and need not be influenced by what they might regard as unusually depressed or high market values. Fair value should, however, bear some reasonable relationship to market value of recent years if a market is available.

Recognition of fair value will, of course, result in a charge to surplus which may be many times greater than the par or stated value. This is very different from the practice of even a relatively few years ago when the Accountant's Handbook, in describing the entries to record a stock dividend, noted that if the dividend is paid-in no-par stock, the amount of surplus is not affected unless each share is given an arbitrary valuation.

The changes in these concepts that have been cited illustrate that accounting is not static. The list is not complete and all the problems have not yet been solved.

Making the Statements Readily Understandable

Whether or not financial statements will ever be properly understood by many of their readers is a moot point. In recent years efforts have been made to simplify the statements and to use non-technical words, though it is difficult to know to what extent the objectives have been attained.

One of the principal proponents of

simplification has been Caterpillar Tractor Company, and a considerable number of companies have followed its example to a greater or lesser degree.

The principal change in the balance sheet is that current liabilities are deducted from current assets and the net working capital shown. To this is added plant and equipment, investments, deferred charges, etc., and from a second sub-total long term liabilities are deducted, bringing out a figure of net assets. This net asset figure is usually followed by a statement of stockholders equity bringing out the same total for capital stock and surplus. It should be noted that under this set-up reserves on the liability side are either classified as liabilities or shown under the stockholders equity section. This is all to the good, for there is little accounting justification, except usage, for dividing the figures into three groups, including an ill-defined section for reserves which, after all, must either be liabilities or an appropriation of surplus.

In the income statement, with the increasing feeling of labor that it is entitled to a large slice of the pie, the breakdown has at times been between purchased materials, wages and salaries, and expenses, rather than the more conventional captions of cost of sales and selling, general and administrative expenses.

Hand in hand with the revised presentation has been a decline in the use of the old, and at least to accountants, familiar words like surplus and reserves.

In place of surplus some companies refer to earnings "employed," or "invested," or "reinvested," or "retained" in the business. "Reinvested" might indicate that they have been invested before, but this would hardly be correct as they were not there to invest. "Invested" might hardly be appropriate if a large part of the increased surplus is represented by, say, cash or marketable securities; in the former case it might be claimed to be not yet invested, and in the latter case it might seem to be invested outside the business. The same thought might occur to some extent with regard to the use of the word "employed"; large cash balances might temporarily be unemployed. "Utilized" is a word which has been suggested as being less specific but having a connotation similar to "employed." The word "retained" seems to be a reasonable counterpart to the profits which have been distributed. It also indicates the exercise of judgment on the part of directors in determining how much profits are to be distributed to stockholders and how much to be "retained"; but objection has been raised on occasion to this word on the psychological grounds that it could be claimed to indicate substantial balances which should be distributed to labor or stockholders and have not.

The word "reserve" is apparently misunderstood and its usage is no longer reommended in the sense of "reserve for doubtful debts," "reserve for depreciation" or "reserve for Federal taxes on income." Instead the American Institute recommends such terms as "less estimated uncollectibles" or "less estimated losses in collection."

Summary

As we go along from day to day it does not seem that there are any very startling developments in accounting. However, when we look back over the changes in our own time, we realize that there have been significant developments in the extent of disclosure, in the form of presentation and in the underlying concepts. No doubt there will be equally significant developments in the future. The changing price level has raised problems especially with regard to inventories and fixed assets. We have already touched briefly on LIFO, and where this method of inventory valuation as been adopted, profits resulting from an increasing level of prices have generally been excluded.

The same principle can, of course, be applied to fixed assets, but so far this has not been encouraged by representative accounting bodies. At present

most companies base depreciation on cost. If the plants were replaced at current prices, the depreciation charge would be much higher and to this extent the income account is not indicative of earnings under present day conditions. Some accountants feel very strongly that a way must be found to overcome this distortion of figures due solely to the fluctuation of the media in which financial statements are expressed. Samuel J. Broad in a recent article in the Journal of Accountancy asks, "Is the postulate, that variations in the purchasing power of the dollar can safely be ignored, still valid." His conclusion is that "Accounting is not performing to the full its function of interpretation if it does not to the best of its ability segregate operating results from gains or losses due to extraneous causes." Whether anything will be done about this will depend to some extent on the rapidity of inflation in the future, but this is cited as an indication that in a changing world there will always be changes in accounting concepts as a result of our attempts to present fairly the financial position and the results of operations.

A Banker Looks at an Audit Report

(Contiued from page 467)

dom from the files of these banks, and the following statistics are of interest:

> Of 110 reports surveyed, 20% of the certificates carried no opinion and no denial of an opinion.
>
> 59% of the certificates did not indicate whether or not receivables had been confirmed or that the auditors had been satisfied by other procedures.
>
> 46% were unclear as to whether the auditors observed inventories or satisfied themselves by other procedures.

An effort was made to compare the results of this sampling with the Detroit survey, and I think the accounting profession will be pleased with the apparent improvement in the three years in that the percentage of those actually confirming receivables increased 30%. The percentage of those failing to express an opinion or to deny one dropped materially, while the percentage of those actually denying an opinion increased substantially. It is rather interesting to note that a rather high percentage of accountants continue to express unqualified opinions even though observation procedures were not indicated. While, admittedly, this survey is too limited to give a complete picture of the situation, nevertheless the fact that the sampling was made at random would seem to give some basis from which to draw conclusions. Certainly, it is a source of satisfaction to realize that the trend seems to be in the right direction.

I have tried to present to you a brief picture of the thinking of some of your banking friends. As I reread my remarks, I was struck by the parallel in our interests. If we adopt the premise that we are both thinking of the best interests of our client, we cannot fail to conclude that what is good for him is good for us and, by the same token, I can say that what is good for the protection of creditors cannot help but be beneficial both to the client and to the accountant.

Mortgagors with "Negative Equities" and "Negative Bases"

By ALVIN D. LURIE, Esq.

Courts and tax practitioners alike are notoriously ill at ease in the presence of problems arising on the disposition of mortgaged property. Particularly troublesome are the cases of "negative equity" and "negative basis"—phrases which describe, respectively, the situations where the mortgage exceeds the value of the property and where the mortgage exceeds the basis. This article discusses the erroneous assumptions that have caused all the trouble in this field, and shows the way to correct analysis and solution of mortgage problems.

SEVERAL recent cases have focused attention on the peculiar problems attendant on the disposition of mortgaged properties with negative equities, i.e., values less than the encumbrances, and negative bases, i.e., bases less than the encumbrances.[1] We have been made accustomed to the anomaly of substantial tax gains to property owners on the loss of their properties in foreclosure. There is obviously something paradoxical about charging a taxpayer with gain from the sale or exchange of property in a year in which he receives nothing of any value: that is, his net assets are not increased; in case of foreclosure for a nominal sum no money or other property comes to him as a result of the foreclosure sale; and if he is not personally liable on the mortgage, no debt for which he is in any way liable is discharged. On the surface, all that happens is that he loses an asset for which he receives nothing. Yet, the cases have taught us that this may be the occasion for a gain where the basis of the property is less than the amount of the mortgage liability discharged, as the converse of the loss that would be realized were the basis higher than the amount of the mortgage.

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The Crane Case

Current thinking on the problems of negative bases and negative equities begins with the *Crane* case. Mrs. Crane had inherited a piece of property worth approximately $250,000, which was then encumbered by a mortgage exactly equal to its value. She proceeded to operate the property under an arrangement with the mortgagee, whereby she collected the rents, paid the taxes and the expenses of repairs and maintenance, and turned the net rentals over

[1] Crane v. Comm'r, 331 US 1 (1947); Parker v. Delaney, 186 F(2d) 455 (1st Cir. 1950); Lutz & Schramm Co., 1 TC 682 (1943); Charles Nutter, 7 TC 480 (1946); O'Dell & Sons Co., 8 TC 1165 (1947), aff'd 169 F(2d) 247 (3d Cir. 1948); Mendham Corp., 9 TC 320 (1947); Woodsam Associates, Inc., 16 TC 649 (1951), aff'd., 197 F(2d)—(2d Cir., 1952).

to the mortgagee to be applied against interest charges. After several years, and with foreclosure imminent, she succeeded in interesting a buyer in the property, and sold it to him for $3,000 cash. The buyer took subject to the mortgage but did not assume it (exactly as she had herself done). During the period of her ownership, she had been allowed depreciation deductions aggregating approximately $25,000.

In rounded figures, Mrs. Crane reported a profit of $3,000 (actually only $1,500, as long-termed capital gain). The Commissioner, however, claimed that her profit was $28,000, arguing that she realized not only the amount of the "boot", but also the full amount of the mortgage (which still equalled $250,000), or a total "amount realized" of $253,000, which had to be compared with an adjusted basis of $225,000 (arrived at by subtracting the depreciation from the original basis of $250,000). The taxpayer conceded that under principles previously laid down,[2] had she been personally liable for the mortgage and had her buyer assumed the mortgage, the assumption would have constituted a taxable benefit to her, and the amount of the mortgage would then have been includible in the "amount realized". But she could not see the benefit to her in the buyer's taking over her property subject to the mortgage for which she was not liable.

The Supreme Court Opinion

The Supreme Court agreed with the Commissioner, saying that the benefit to the mortgagor not personally indebted is as real as if a personal debt had been assumed by the buyer. The only reason it offered for this conclusion was that "an owner of property, mortgaged at a figure less than that at which the property will sell, must and will treat the conditions of the mortgage exactly as if they were his personal obligations." The court then went out of its way to state that if the value of the property were less than the amount of the mortgage—what we have called above a case of negative equity—"a mortgagor who is not personally liable cannot realize a benefit equal to the mortgage." The court, with doubtful justification, took the buyer's willingness to pay cash over the mortgage as proof that the value of the property in this case was greater than the mortgage. The opinion thus invites the speculation that Mrs. Crane might have been better off to give the property away without taking any "boot". At best, the opinion leaves one groping, as perhaps the court was itself, for the rationale of the rule applied, and of the suggested exception in "negative equity" cases as well.

It is the burden of this paper that the court properly found a taxable benefit in the *Crane* case,[3] but that it may have fastened on the wrong element in so doing; and thus its opinion serves to perpetuate bad doctrine.

Components of Mortgagor's Transaction

The sale of mortgaged property has two distinct elements, the disposition of the property and the discharge or assumption of the mortgage debt. Each of these may have its own separate tax consequences. The property disposition produces gain (or loss), as on a sale or exchange under Internal Revenue Code, Section 111, depending upon the relation of the "amount realized" to the basis. The debt payment, or debt assumption which is its equivalent, normally has no tax consequences

[2] See Brons Hotel, Inc., 34 BTA 376 (1936); Walter Haass, 37 BTA 948 (1938).

[3] There is only this reservation about the correctness of the Crane result: the decision required the taxpayer to adjust her basis for $25,000 of depreciation taken, and therefore in effect, to pay tax on this depreciation when the property was disposed of by reason of the operation of the lowered basis, notwithstanding the fact that the taxpayer enjoyed tax savings of only about $150 from the depreciation deductions. But this is a charge more against Virginian Hotel Corp. v. Helvering, 319 US 523 (1943) (wherein depreciation deductions were removed from the sphere of the "tax benefit" rule) than against the Crane case.

(unless the debt is assumed or discharged at a discount, in which event ordinary income from the gratuitous cancellation of indebtedness may be realized).

Elements Are Interrelated

The two elements are necessarily interrelated and easily confused, because the discharge from, or assumption of, the mortgage accrues to the owner as consideration for the disposition of the property. Thus, because the consideration takes the form of debt discharge or debt assumption to the extent of the mortgage, it is almost irresistible to characterize the taxpayer's realization of income as stemming from debt assumption or discharge, as the court seems to have done in the *Crane* case. This made it necessary for the court to find debt assumption, which created difficulty because of the taxpayer's lack of personal liability for the mortgage.

Need of Debt Assumption to Support Tax

In other words, the court appears to have been trapped into looking for an equivalent of debt assumption in order to support a tax, when, in fact, a buyer's assumption of the mortgage is not what gives rise to tax. There are principally two arguments which have been made to show the dependence of the tax on debt assumption. The more naive of these is that taxable income can arise only on a release from liability, and where the owner is not liable for the mortgage debt, the disposition of his property does not effect for him a release from liability. This argument simply confuses the concept of debt cancellation income with income or gain attributable to the consideration received on the disposition of property. While in these cases the consideration for the property often takes the form of debt assumption, or its equivalent, the applicable concept is gain on the exchange of property *for a valuable consideration,* as to which the gratuitous release from liability has no relevancy.

The other argument, and the one which seems to have bothered the court in the *Crane* case, correctly treats debt assumption as merely a form of consideration for the property, but maintains that without debt assumption there is no consideration, and, therefore, no taxable benefit and, consequently, no income. What this argument fails to apprehend is that, even in the case of a seller personally liable on the mortgage, the buyer's assumption of the liability is not what gives rise to taxable income on the disposition of the property. Admittedly, the taxable benefit in such a case is commonly characterized as derived from assumption of indebtedness. But that terminology obscures its true nature. Observe that the mortgagor must give up property of a value equal to the debt to get the benefit of the debt assumption. It is not as if the seller were having his mortgage debt assumed gratuitously. In the latter case, of course, there would be income, just as in the case of debt cancellation.

Debt Assumption Not Income

But where, as part of the very transaction in which the liability is assumed, property of an amount at least equal to the liability is given up without any consideration other than the assumption of the liability, there is no taxable income by reason of the assumption. It is quite the same as if the taxpayer, owing \$10 to Y, paid this sum to Y, or, more nearly, as if the taxpayer, owing this debt to Y, paid the \$10 to X who assumed the debt. The only difference, where the taxpayer instead of paying \$10 cash to X, transfers to X property worth \$10 on the same terms, is that the taxpayer is also disposing of a piece of property.

It is the disposition of the property that gives rise to taxable income in the latter instance. The taxable benefit lies in the payment received for it. The debt assumption, serving as an

element of the payment, constitutes good consideration for the property, and figures in the gain or loss from the disposition of the property; but it is not the tax producer. Thus, where the taxpayer paid $10 to X to have him assume an obligation to Y, he got good consideration for his $10, but he did not realize any taxable income because of it. In the same way, where the taxpayer transferred property to X in consideration for X's assumption of a liability to Y, the taxpayer did not realize any income or incur a tax *because X assumed his liability.* He realized income only *because he disposed of his property at a profit.* In fact, had his basis been greater than the market value of the property, he would have realized a loss.

Personal Liability As a Factor

An owner of mortgaged property will receive the same amount of consideration on the disposition of his property whether or not he is personally liable on the mortgage. Debt assumption may be lacking as an element of consideration in cases of unindebted mortgagors; but that does not make for an absence of any consideration, unless the unindebted mortgagor is to be assumed to have given up his property without receiving any consideration to the extent of the amount of the mortgage. This is obviously absurd, because the unindebted mortgagor has no less to sell, and is entitled to no less consideration, than the indebted mortgagor. The latter can command no more cash over and above the mortgage than the former. In each case the amount of the mortgage is automatically an offset against the amount of cash that would otherwise be paid for the property. The amount of this offset is readily conceded to be part of the consideration received by the latter, because it represents a debt for which he is personally liable. But the owner's personal liability, or lack of it, obviously has no bearing on the amount of consideration he is entitled to receive for his property. The only thing that affects this is its intrinsic value; and the owner is fully compensated for his property if he receives on its transfer the amount of the intrinsic value in cash and lien extinguishment.

That the lien extinguishment is without *personal* benefit to the unindebted mortgagor is no bar to its recognition as part of the consideration received for the property. The mortgage, even though not personally owed, is, after all, payable out of the charged property, and so is in a sense a debt of the property owner with merely the source of payment limited.[4] In terms of a taxpayer's net worth, he is just as well off to get, in exchange for the property, release from a debt collectible only out of that property (assuming the property is worth at least as much as the debt), as he is to have a debt for which he is personally liable assumed by another or discharged.[5]

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[4] Judge Learned Hand stated this succinctly in the following excerpt from the Circuit Court's opinion in the Crane case, 153 F(2d) 504 (2d Cir. 1945):

"The mortgagee is a creditor, and in effect nothing more than a preferred creditor, even though the mortgagor is not liable for the debt. He is not the less a creditor because he has recourse only to the land, unless we are to deny the term to one who may levy upon only a part of his debtor's assets. When therefore upon a sale the mortgagor makes an allowance to the vendee of the amount of the lien, he secures a release from a charge upon his property quite as though the vendee had paid him the full price on condition that before he took title the lien should be cleared, or as though it were a condition upon the sale of Whiteacre that the vendee should clear the vendor's Blackacre of a mortgage. In neither case would anyone question the conclusion that the vendor had received 'property (other than money)'; yet the effect is precisely the same of the transaction at bar."

[5] Analogously, the gratuitous cancellation of a debt collectible only out of property would result in ordinary income, to the extent the taxpayer's equity were increased, in the same way as if he were personally liable therefor. See Central Paper Co. v. Comm'r, 158 F(2d) 131 (6th Cir. 1946).

Effects of Confusing Separate Components

Had the *Crane* court more fully appreciated the significance of the fact that the assumption of indebtedness is not what gives rise to the realization of income in any case, it would not have found it so difficult to state the rule in the case of the seller of mortgaged property who is not liable on the mortgage and therefore has no liability to be assumed. But at least the correct result was reached. Not as much can be said for many other cases in the field, which have confused the consequences of the assumption or discharge of debt with those of the disposition of property.

Debt Cancellation Income Called Gain on Sale

Where the mortgagee has accepted a conveyance of the property in lieu of foreclosure and in full discharge of the debt, even though the property was worth considerably less than the mortgage, the courts have held that the entire amount of the mortgage constituted the "amount realized" on the disposition of the propery, notwithstanding that the excess of the amount of the mortgage over the value of the property represented pure debt cancellation, normally taxable as ordinary income[6] to a debtor.

Loss Attributed to Mortgage Debt Instead of to Disposition of Property

In a case of foreclosure, where the mortgagor dropped his property on foreclosure in one year, suffering a deficiency judgment which he did not pay until a later year, the entire transaction resulting in a loss, the Tax Court has made the loss seem to be attributable to the payment of the mortgage debt rather than to the disposition of the property, by allowing the loss in the later year.[7]

Nonrecognition of Consideration if no Boot

Many courts have reached opposite results in almost indentical cases, the decisions turning on slight factual differences. Perhaps the most notorious pairing is of the cases, on the one hand, allowing an ordinary loss if an owner not liable on the mortgage voluntarily surrenders his property to the mortgagee without receiving "boot", and, on the other hand, limiting the owner to a capital loss if he receives even a slight cash consideration from the mortgagee—$250 in one case.[8] The rationale for allowing an ordinary loss is that the receipt of "boot" makes the disposition of the property one for a consideration, but that without "boot" the unindebted owner receives no consideration for his property, because, it is said, there is no consideration in the extinguishment of a lien for which the owner was not personally liable; and so the transaction is not a "sale or exchange".

This nonrecognition of consideration to the unindebted mortgagor in the absence of "boot", and the resultant negation of a "sale or exchange", is perhaps the most recurring error in the whole field. A variation of it occurs in the cases allowing the mortgagor an ordinary loss if his personal liability is extinguished prior to the conveyance to the mortgagee, and only a capital loss if the personal liability is extinguished in consideration of the voluntary conveyance.[9] But note that foreclosure in every instance produces capital loss (or gain) because foreclosure is said to involve a sale *per se,* and thus, the reasoning goes, it is not

[6] Peninsula Properties Co., 47 BTA 84 (1942); cf, O'Dell & Sons Co., 8 TC 1165 (1947), aff'd 169 F(2d) 247 (3d Cir. 1948).

[7] Charles Black, 45 BTA 204 (1941); cf. Harry Diamond, 43 BTA 809 (1941).

[8] Compare Polin v. Comm'r, 114 F(2d) 174 (3d Cir. 1940), and Stokes v. Comm'r, 124 F(2d) 335 (3d Cir. 1941), with Blum v. Comm'r, 133 F(2d) 447 (2d Cir. 1943).

[9] Compare Bert B. Burnquist, 44 BTA 484 (1941), with Richter v. Comm'r, 124 F(2d) 412 (2d Cir. 1942).

necessary to show consideration passing to the owner in order to qualify the transaction as a "sale or exchange".[10]

The *Crane* case itself suggested that the result might have been different there had the owner not received the boot. In fact, the intermediate court in the *Crane* case went so far as to say that, if the owner had surrendered the property to the mortgagee or abandoned it without receiving boot, she could not be charged with the amount of the mortgage as consideration received on a "sale or exchange" of her property.[11] The effect of this would have been to allow her to escape accounting for the depreciation she deducted during her period of ownership of the property.[12]

Gain on Abandonment

A recent decision has indicated, however, that even an abandonment would not have avoided for the taxpayer the duty of accounting for her depreciation; but the decision pointed out that in case of an abandonment, the amount thereof would be taxable as ordinary income rather than capital gain because of an abandonment not being a "sale or exchange".[13] The idea of any income being realizable as a result of abandonment, whether ordinary or capital gain, is strange indeed. It is like saying that a casualty, such as a storm, which wipes out a taxpayer's investment, may be productive of income.

The court viewed ordinary income on an abandonment as simply the converse of the ordinary loss found in other cases of the abandonment of mortgaged property.[14] It is submitted that there is no real converse to an abandonment loss, any more than there could be a converse to a casualty loss. Perhaps the answer is to declare that mortgaged property cannot be "abandoned", within the meaning of that concept for tax purposes.[15] That is, if the property has any value, the mortgagee will claim it and satisfy his debt out of it; and to this extent the owner receives consideration even on an abandonment, with the result that he has capital gain or loss the same as on a sale or exchange.

Need for Statutory Correction

The absurd development of these disparate rules—where the receipt of a little "boot" may change an ordinary loss into a capital loss, or, more significantly, may require the inclusion in income of sums otherwise unaccountable for; where a voluntary conveyance in lieu of foreclosure is one thing, but a foreclosure is another, and an abandonment is something else again—are more products of the *Crane* type of approach, deriving from the misconception of significance of debt assumption or discharge to the realization of income on the disposition of mortgaged property.[16] The result of this sort of thinking has been to bestrew this corner of the tax law with meaningless distinctions which even skilled commentators have been hard put to ex-

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[10] Helvering v. Hammel, 311 US 504 (1941).

[11] Comm'r v. Crane, 153 F(2d) 504 (2d Cir. 1945).

[12] The commentators have expressed mixed reactions to the possibility of the taxpayer's being able to avoid accounting for excess depreciation by abandoning his property. Compare Braunfeld, *Subject to a Mortgage I*, 24 Taxes 424, 442, n. 55 (1946), with Note, 60 Harv. L. Rev. 1324 (1947).

[13] Parker v. Delaney, 186 F(2d) 455 (1st Cir. 1950).

[14] See Polin v. Comm'r, 114 F(2d) 174 (3d Cir. 1940); Rhodes v. Comm'r, 100 F(2d) 966 (6th Cir. 1939).

[15] See strong argument to this effect in Braunfeld, supra, n. 12, at 436-445.

[16] For a complete summary of the cases, see Rabkin & Johnson, Federal Income, Gift and Estate Taxation, § 44.05.

plain.[17] Statutory correction is sorely needed here; and, in fact, the American Law Institute has made a promising start in this direction in its project to restate the Internal Revenue Code.

"Negative Equity" vs. "Negative Basis"

In the structure of almost every difficult case in the mortgage field—and the foregoing are no exceptions—is a negative equity. It would be well first to define the phrase "negative equity", especially since it has been frequently confused with the similar phrase, "negative basis". A negative equity is occasioned whenever the mortgage exceeds the value of the property, so that there is an absence of any value to the owner's equity; viz., property value 7, mortgage 10, basis (which is irrelevant to the problem) 13. It is to be contrasted with a negative basis, where the mortgage exceeds the basis; viz., basis 6, mortgage 10 and value (which is irrelevant in this case) 12. Obviously, the two can be combined, so that the mortgage exceeds both the basis and the value, and these latter two may be more or less than one another; viz., basis 6, value 7 (or vice versa), and mortgage 10.

Problems of "Negative Basis" Alone

Before we examine the last one, let us see what happens in case of negative basis alone. The *Crane* case has told us that where a mortgage is reflected in the purchase price of property, as where the buyer gives a purchase money mortgage, or assumes an existing one, or even simply takes subject to one, the mortgage is counted in the tax basis of the property, so that a purchase price of $3 cash and $10 in mortgages produces a basis of $13. The basis may become negative in several ways. Thus, if the taxpayer deducts more depreciation than his cash investment, he has a negative basis;[18] viz.:

Original cash	3
Mortgages	10
Unadjusted basis	13
Less depreciation	7
Adjusted basis	6

Mortgaging Over Cost

The negative basis may also come about in an inflated real estate market when the owner secures a mortgage on his property, some time after he acquires it, for an amount in excess of his original cost (or, at least, his adjusted cost after depreciation). The argument was made, unsuccessfully, in a recent case that such mortgaging over cost *without personal liability* is a taxable event and creates Section 111 income for the owner. Were this argument sustained, there would not be a negative basis because the property would ac-

[17] A considerable amount of excellent literature has accumulated, but it is submitted that most of it is hampered by the authors' acceptance of the necessity of finding debt assumption, or its equivalent, as the basis for income on dispositions of mortgaged property. Braunfeld, *Subject to a Mortgage* (3 parts), 24 Taxes 424 (1946), 24 Taxes 557 (1946), and 25 Taxes 155 (1947); Moorehead, *How to Handle Foreclosures, Settlements between Mortgagor and Mortgagee and other Mortgage Disposition,* Proc. N.Y.U. 6th Ann. Inst. on Fed. Taxation 399 (1948); Engel, *Effects of the Crane Case,* Proc. N.Y.U. 6th Ann. Inst. on Fed. Taxation 379 (1948); Meyer, *Disposition of Real Estate Where Mortgage Indebtedness Exceeds Tax Basis,* Proc. N.Y.U. 7th Ann. Inst. on Fed. Taxation 338 (1949); Greenlee & Kramer, *The Mortgagor with a Negative Basis,* 27 Taxes 887 (1949); Notes, 13 U. of Chi. L. Rev. 510 (1946), 60 Harv. L. Rev. 1324 (1947), 49 Col. L. Rev. 845 (1949).

[18] The Crane, Parker, Lutz & Schramm, O'Dell and Mendham cases, cited in note 1, supra, all illustrate this. The allowability of depreciation even after the cash investment has been recovered has been tacitly approved in the Crane case; see also Woodsam Associates, Inc., 16 TC 649 (1951), aff'd., 197 F(2d)—(2d Cir., 1952). For good treatment of the problem of depreciation of mortgaged property, see Braunfeld, *Subject to a Mortgage III,* 25 Taxes 155 (1947); Notes, 13 U. of Chi. L. Rev. 510 (1946); 26 Texas L. Rev. 796 (1948), 6 Tax L. Rev. 319 (1951).

quire a stepped-up tax basis equalling the mortgage.[19]

FHA-Section 608

Currently we are witnessing still another type of transaction productive of a negative basis, the FHA-Section 608 deals, where the taxpayer may under some circumstances come out with a larger mortgage than his cost of the project, the so-called "mortgage out" money situations.[20]

Mortgage as Consideration to Owner

The problem in all of these cases is whether the full amount of the mortgage can be included in the consideration deemed to be received by the owner on a sale or foreclosure. The mortgage is included where, on a sale, the owner is personally liable and the buyer assumes the mortgage.[21] The mortgage is also included where the buyer does not assume the owner's personal liability, but merely takes subject to the mortgage.[22]

The finding of consideration in the latter case is made difficult by the erroneous formulation of the problem in terms of debt assumption, as witness the ingenious arguments which have been brought forth by way of justification.[23] In truth, there is no less reason for charging the owner with income where his buyer does not assume the mortgage debt, because the only extra benefit that would accrue to him if his buyer did assume would be the release from primary liability for a deficiency judgment in the event the property subsequently declined in value below the amount of the mortgage and was foreclosed. This benefit is at most a contingent one, and hardly such as should justify a different tax result in cases where buyers assume the mortgage, on the one hand, and those where they do not, on the other.

We have seen in the *Crane* case that the full amount of the mortgage is included on a sale even though the owner is not personally liable for the mortgage.[24] This result has also been extended to cases of foreclosure sales, irrespective of whether the owner is personally liable.[25]

Thus, the same result is reached in all cases: where the seller's mortgage is assumed, where it is not, where the seller is himself not liable; where the property is sold to a stranger, or conveyed to the mortgagee in lieu of forclosure, or even where it is foreclosed. The reason these differing factors do not affect the tax result has already been stated.

Problems of "Negative Equity"

Indebted Mortgagor

The problem whether to include the full amount of the mortgage in the consideration received is compounded where the property is worth less than the mortgage, and the mortgagee nevertheless accepts a conveyance of the property in full discharge of the debt. The problem also comes up on foreclosure, when the mortgagee waives the deficiency. Illustrative figures to consider are: basis 6, value 7, and mortgage 10.

Where the owner was personally liable on the mortgage, it seems perfectly obvious that in this situation he has received the benefit of some debt can-

[19] Woodsam Associates, Inc., 16 TC (1951), aff'd., 197 F(2d)—(2d Cir., 1952). For statement of the taxpayer's argument, see Note, *Mortgagor's Gain on Mortgaging Property for More than Cost without Personal Liability*, 6 Tax L. Rev. 319 (1951).

[20] See Marks, *Income Tax Problems of Operative Builders*, Proc. N.Y.U. 9th Ann. Inst. on Fed. Taxation 933 (1951).

[21] See cases cited supra, n. 2.

[22] See Reg 111 § 29.113(a)(6)-2, Example 2.

[23] See Braunfeld, supra, n. 12; Note, 60 Harv. L. Rev. 1324 (1947).

[24] See also Parker v. Delaney, 186 F(2d) 455 (1st Cir. 1950).

[25] O'Dell & Sons Co., 8 TC 1165 (1947), aff'd 169 F(2d) 247 (3d Cir. 1948); Mendham Corp., 9 TC 320 (1947).

cellation. This is ignored if the full amount of the mortgage is viewed as having been discharged by the mortgagee in consideration for the receipt of the property. In the normal case, where property is transferred in discharge of the transferor's debt, consideration flows to both parties: to the property owner for his property, in the form of debt discharge; to the creditor as consideration for the debt he gives up, in the form of property.

But if the property is worth less than the debt, the creditor only receives *pro tanto* consideration for his debt—on the above figures, only 7 out of the 10. Conversely, the only consideration he gives to the property owner is *pro tanto* discharge of the debt; the balance of what he gives to the property owner is gratuitous forgiveness of the unsatisfied portion of the debt. The property owner does not get this portion of the debt discharge as consideration for his property, any more than, if he had paid the creditor an equal amount in cash, it could be said that the *full* amount of the debt discharge was attributable to and given in consideration for the cash payment.[26]

The cases have, nevertheless, ignored the debt forgiveness feature, and called the entire amount of the difference between the basis and the mortgage capital gain on the disposition of the property.[27] In a loose sense, of course, the debt is being given up for the property, and perhaps the simplicity of operation warrants the merging of the debt cancellation and the true consideration. The only effect of this is to convert ordinary income into capital gain (with judicial sanction). Moreover, in cases warranting application of the "reduction of cost" theory as a substitute for debt cancellation income, the same tax result would follow as demonstrated below.[28]

Unindebted Mortgagor

But where the owner is not personally liable, it is hard to justify counting the full amount of the mortgage, even under any relaxed theory of consideration. His debt is limited to the value of his property since that is the only source of its payment. Any excess of the mortgage over the value of the property must be extinguished willy-nilly, and cannot be productive of debt cancellation income.[29] Consequently, to charge him with the full amount of the mortgage constitutes more than just converting ordinary debt cancellation income into capital gain. The *Crane* case gave passing mention to this problem in the following terms:

> "Obviously, if the value of the property is less than the amount of the mortgage, the mortgagor who is not personally liable cannot realize a benefit equal to the mortgage. Consequently, a different problem might be encountered where a mortgagor abandoned the property or transferred it subject to the mortgage without receiving boot."[29a]

But the cases which have had to decide the problem have reached the same result as where the mortgagor is personally liable, that is, they have included the full amount of the mort-

[26] For more detailed exposition of this argument, see RABKIN & JOHNSON, op. cit., supra, n. 16, at § 36.06.

[27] O'Dell & Sons Co., 8 TC 1165 (1947), aff'd 169 F(2d) 247 (3d Cir. 1948) (foreclosure); Peninsula Properties Co., 47 BTA 84 (1942) (voluntary conveyance).

[28] See Hirsch v. Comm'r, 115 F(2d) 656 (7th Cir. 1940); see also RABKIN & JOHNSON, op. cit., supra, n. 16, at §§ 36.05, 36.06; cf. Comm'r v. Jacobson, 336 US 28 (1949). The merging of the debt cancellation and the property disposition can adversely affect the taxpayer, if under Helvering v. American Dental Co., 318 US 322 (1943), he could otherwise treat the debt cancellation as a nontaxable "gift"; for then, presumably, he would not even have capital gain. Cf. Charles Nutter, 7 TC 480 (1946).

[29] See Fulton Gold Corp. 31 BTA 519 (1934); P. J. Hiatt 35 BTA 292 (1936); Hotel Astoria, Inc. 42 BTA 759 (1940); cf. Charles Nutter, 7 TC 480 (1946).

[29a] 331 US at 14, n. 37.

gage as capital gain.[30] There is obvious practical and equitable justification for this result, because otherwise the taxpayer might escape accounting for excessive depreciation, or for the mortgage profit he realizes when he mortgages over cost.

Reconciling Legal Theory and Equity

Perhaps there is a way of reconciling the demands of legal theory and equity. A just tax result can be achieved without disturbing the legal principles if the excess of the mortgage over the value of the property is viewed as debt forgiven, and the property owner's basis is reduced by the amount forgiven. This is the technique that is employed in the "reduction of cost" cases,[31] and also under I.R.C. § 22(b)(9) with respect to the option granted to corporations to defer debt cancellation income.

The justification for extending this technique to the case of an unindebted mortgagor is that if his basis includes the full amount of his mortgage, or if the basis reflects an amount of original cash investment which has been subsequently recouped through a subsequent mortgage borrowing, it is obviously unfair to allow him to compute gain or loss with all of this in his basis, if he is not also required to account for this amount, via inclusion of the full amount of the mortgage, on the disposition of the property. The suggested technique would take out of the basis that part of the mortgage which is not accounted for on disposition—that is, the excess of the mortgage over the property's value—and require the property owner to count as consideration for his property only the value of the property.

Since the cases have achieved the same tax result as this technique with much less complexity, its value may be questioned. However, if nothing else, it does serve to prove the correctness of the results under the cases, and therefore makes them supportable despite their theoretical impurity.

Nominal Sales to Strangers

In the usual case of property owned with a negative equity, the seller can only dispose of his property to the mortgagee, or drop it on foreclosure. He cannot get a stranger to buy the overmortgaged property (outside of foreclosure). However, occasionally a trader will take such a property for a nominal sum, either to run away with the first rents or in a gamble on a rising market. The taxable transaction in the *Crane* case appears to have been such a deal; although the court refused to view the property as being worth less than the mortgage, presumably to avoid what it called the "different problem" of negative equities.[32]

The question occurs whether, in view of the special problems of negative equities, the owner should be required to include in his "amount realized" the full amount of the mortgage plus the "boot", just as if the property were actually worth more than the mortgage and commanded the boot on its market value. Since the cases include the full

[30] Woodsam Associates, Inc., 16 TC 649 (1951), aff'd., 197 F(2d)—(2d Cir., 1952); Lutz & Schramm Co., 1 TC 682 (1943); cf. Parker v. Delaney, 186 F(2d) 455 (1st Cir., 1950); Mendham Corp., 9 TC 320 (1947).

[31] See cases cited supra, notes 28, 29.

[32] It is interesting to observe how the courts have struggled to avoid this problem. In the Crane case, the court jumped on the buyer's willingness to give some "boot" as proof of a positive equity. See Parker v. Delaney, 186 F(2d) 455 (1st Cir. 1950), where the taxpayer took over property held by a bank after foreclosure, giving back only a mortgage and no cash, and then operated it for about 10 years, quitclaiming it to the bank when the mortgage was in default. The court said there was no evidence that the value of the property was less than the mortgage! And in Woodsam Associates, Inc., 16 TC 649 (1951), aff'd., 197 F(2d)—(2d Cir., 1952), the court refused to make a finding as to the value of the property, notwithstanding unchallenged testimony that it was worth roughly $60,000 less than the mortgage.

mortgage even in cases of negative equity, it would seem that the same result should follow in these hybrid cases, *a fortiori,* with the addition of the "boot" to the "amount realized". Furthermore, it does not make any difference to the seller why the buyer is taking over the property and paying a nominal sum, so that it would be hard to justify a different result from the cases of actual positive equity.

There is only one possible exception to this: where the owner is liable on the bond, but the buyer does not assume it. Here, since the property is worth less than the mortgage and, as events stand then, it is likely that the seller will be called upon to satisfy a deficiency judgment in the future, it is questionable whether it is good policy to charge him with the full amount of the mortgage plus the "boot" at the time of his sale, only to give him a compensating loss when the deficiency is subsequently required to be paid. The preferable alternative would seem to be to charge him with only the value of the property plus the "boot" as consideration received on his sale, and to charge him with additional income (probably debt cancellation income) only if the mortgage is subsequently discharged without his having to pay any deficiency. Authorities are lacking either way.

Conclusion

In any summary of this subject, the principal point to be emphasized is the absence of significance of debt assumption or debt payment to any realization of income on the disposition of mortgaged property, at least where the property is worth more than the mortgage. Income realization stems solely from the disposition of the property, and so the distinction of cases on the basis of whether or not the owner's debt is assumed, or of whether he even has a debt to be assumed, should be swept away, as should the distinctions based on kind of disposition, viz., sale, surrender, abandonment, etc. Cases making these distinctions rest on an inadequate comprehension of the significance of the separate elements of debt payment and property disposition inhering in every disposition of mortgaged property. The tax result in all these cases should be the same, with the full amount of the mortgage being included as consideration for the property. Even in cases where the property is worth less than the mortgage, and where there may be an element of debt forgiveness on the disposition, practical considerations seem to warrant a harmonious result with the positive equity cases. The need of legislation in this field cannot be overemphasized.

The 113th New York Certified Public Accountant Examination

May 14, 15 and 16, 1952

THEORY OF ACCOUNTS

Friday, May 16, 1952—1.30 to 5 p. m., only

This paper is intended to test the extent of your knowledge of accounting theory and your ability to apply the knowledge you have acquired. Due weight will be given to the arguments presented to support your answer to each question, even though the examiners may not agree with your conclusions.

Answer questions 1 through 7 and either question 8 or question 9.

1 Some accountants have argued for an "all-inclusive" income statement while others have insisted that at times certain items should be charged to retained earnings or otherwise kept out of the net income figure.

Explain fully the position of each of these two groups and give the principal arguments offered by each group. [15]

2 There has been an increase in the number of businesses that value inventories on a last-in, first-out basis. Some accountants believe that a business using the LIFO basis should disclose in its financial statements the current market value of an inventory valued under that method. Give the arguments for and against this proposed disclosure. [10]

3 In manufacturing activities, a portion of the units placed in process are sometimes spoiled and become practically worthless. Discuss two ways in which the cost of such spoiled units could be treated in the accounts and describe the circumstances under which each method might be used. [12]

4 A vacant piece of land is purchased for use as a parking lot. In addition to the cost of the unimproved land, expenditures are made for grading, drainage, paving, curb and gutter, marking of parking spaces, and lighting installations. Which, if any, of these costs are subject to depreciation? Explain the general principle that is involed. [8]

5 [15]

The Jones Co. sells furniture on the installment plan. For its federal income-tax returns, it reports its profit from sales on the "installment basis." For its financial reports, it considers the entire profit to be earned in the year of sale.

a Discuss the relative merits of the two methods of reporting income.

b Explain the installment basis as used for income-tax purposes.

c Discuss the effects of the use of these two bases by the Jones Co. on the significance of its reported annual income.

6 [10]

The M Company and the N Company are engaged in a similar manufacturing business and have approximately the same annual sales volume. Their condensed balance sheets at December 31, 1951, show the following condition:

	M	N*
Cash	$ 65,000	$173,500
Receivables	81,500	77,000
Inventories	217,000	232,000
Plant and equipment (net)	890,500	—
	$1,254,000	$482,500
Current payables	$ 74,500	$ 61,500
Bonds payable	750,000	—
Stock and retained earnings	429,500	421,000
	$1,254,000	$482,500

* N is liable under a ten-year lease for $174,000 annual rental of plant and equipment used in their manufacturing operation.

Assuming that you have profit and loss statements and detailed operating figures available for both companies, state in what major ways you would expect to find the statements differing and explain how you would adjust the figures to obtain comparable manufacturing costs for the two companies.

7 [15]

Some items in accounting statements are expressed in current dollars, while other items are normally expressed in dollars of a prior year or years.

a Name the principal balance-sheet items which might not be expressed in current dollars. If any part of your answer depends on the accounting procedures employed, explain fully.

b Name the principal items in the income statement that might not be expressed in current dollars. If any part of your answer depends on the accounting procedures employed, explain fully.

c Name the principal items in the statement of source and application of funds that might not be expressed in current dollars. If any part of your answer depends on the accounting procedures employed, explain fully.

Answer either question 8 or question 9.

8 [15]

a State the principal reasons for the use of several funds in the accounts of governmental units.

b List *five* kinds of funds frequently found in the accounting system of a municipality and discuss briefly the content of each.

9 Accounting information is frequently used by governments as an important element in setting sales prices or establishing rates that may be charged for services. The Federal Power Commission, in connection with its interest in rates charged by electric companies, has prescribed a uniform system of accounts that has been adopted by many state regulatory bodies.

This system calls for carrying the fixed assets at "original cost," with any excess which was paid by the accounting company recorded in a "Plant adjustment" account. "Original cost" is defined as the cash cost of the property to the person first using it in public service.

Discuss this accounting requirement from the point of view of general accounting theory and from the standpoint of its use in the regulation of rates. [15]

COMMERCIAL LAW

Friday, May 16, 1952—9 a. m. to 12.30 p.m., only

Reasons must be stated for each answer except for objective type questions; no credit will be given for an answer unsupported by a statement of reasons. Whenever practicable, give the answer first and then state reasons. Answers will be graded according to the candidate's evident knowledge of the legal principles involved in the question rather than on his conclusions. Answers to questions involving negotiable instruments, partnerships and sales should be based on the provisions of the pertinent Uniform Law.

Group I—Answer all questions in this group.

1 [10]

You are a holder in due course of a negotiable instrument in the amount of $100, payable on April 1, 1952. Answer the following questions:

a If the maker could prove that he had received no consideration for the instrument, could you recover $100 from him at maturity, assuming that he were solvent? Explain.

b If the payee had indorsed the instrument in blank and you wished to recover the face of the instrument from him, what would you have to do to recover?

c Assume that the maker could prove that he had delivered the instrument to the payee upon a condition, which condition had not happened, and also

that the payee had sold the instrument to you, who knew nothing of the condition. Could you recover $100 from the maker at maturity? Explain.

d If you should sell the instrument to your bank on April 3, could the bank recover from the maker in cases *a* or *c* above? Give reasons.

2 [10]

a S was a surety for P upon a $5,000 obligation in favor of C.

(1) At the maturity of the obligation P defaulted. S did not learn of this until eighteen months thereafter when C demanded payment of him. Is S still liable? Explain.

(2) P, being insolvent, paid $1,800 to C who released P from all further liability. May C recover the remaining $3,200 from S? Why?

b P desired credit with C, but the latter required a guaranty to protect himself against loss. At P's request, S and X wrote letters, each knowing what the other had done. S guaranteed P's credit up to $10,000 and X guaranteed it up to $20,000, both guaranties being continuous in character.

(1) P became insolvent when he was indebted to C to the extent of $9,000. S was compelled to pay the full amount. To what extent may S obtain contribution from X? Explain.

(2) If S is in possession of collateral worth $3,000 given by P to protect S against loss from his guaranty, how would this influence your answer to (1) above? Explain.

3 [10]

a Define and distinguish between a "sale on trial" and a "sale or return."

b A seller of goods, pursuant to contract, delivers the goods to a carrier for transmission to the buyer. The buyer is required under the contract to pay the shipping costs and to pay for the goods before obtaining possession. Which party bears the risk of loss of the goods during the journey? Why?

c Name four warranties that are made by the indorser of an order bill of lading when he negotiates the document to a purchaser for value.

d What rights has the buyer when the seller delivers to him a larger quantity of goods than called for by the contract?

4 [10]

a May an unincorporated club or other unincorporated voluntary association acting as a club or association, appoint an agent? Why or why not?

b If an agent fails to bind his alleged principal to a third party because the agent has no authority to represent such principal, suggest and explain two remedies which the third party might have against the agent.

c What is a *del credere* agent?

5 [10]

a Define the term "promoter" in connection with the law of corporations.

b Is a corporation liable for contracts made by a promoter for the corporation before the corporation comes into existence? Why?

c What is a quorum? What is the difference between a quorum of the stockholders and a quorum of the directors?

d May a majority of the directors, acting individually, bind the corporation? Explain.

Group II—Answer any five questions in this group.

6 [10]

a A had owned and operated a restaurant in the town of X for the last 10 years. Learning that B intended to open a competing restaurant in the same town, A entered into a written contract with B under which contract he paid B $5,000 and B agreed not to open the new business. Is this an enforceable contract? Explain.

b Suppose that A had sold his restaurant to B for $25,000, the sale including real property, fixtures and good will. A, having agreed not to do so, now proposes to start a new restaurant across the street from his old location. May he legally do so? Give reasons to support your answer.

c Suppose that in problem *b* above the contract had included a term in which A agreed never to start a restaurant in the state where the town of X is located. Is this provision enforceable? Why?

7 [10]

a What is the major advantage of a negotiable instrument as contrasted with one which is non-negotiable?

b What are the requirements to create a negotiable instrument?

c What would be necessary to negotiate the following?

(1) an instrument payable to cash or order
(2) an instrument payable to bearer or order
(3) an instrument payable to the order of a designated payee
(4) an instrument payable to accounts payable or order

d Name and explain the effect of four types of indorsements which may be used in the negotiation of negotiable paper.

8 [10]

a Indicate what is meant by each of the following terms as used in connection with insurance:

(1) valued policy, (2) open policy.

b What is an insurance binder?

c Distinguish between insurance and a wager.

9 [10]

a What is the difference between a private carrier and a common carrier?

b What is the difference in liability of a private carrier and a common carrier of goods for damage to goods while in transit? List *four* circumstances in which the common carrier of goods is not liable for damages to goods while in transit.

c Name *three* occasions when a common carrier of goods may justifiably refuse to accept goods for transportation.

10 [10]

a List *five* ways in which a lease may be terminated.

b What is the difference between an assignment of a lease and a sub-lease?

11 [10]

On your paper you are to list the numbers 1 through 10. Opposite each number you are to write the word "True" if the statement is true or the word "False" if the statement is untrue. Grade will be based on the number of correct answers. No reasons need be given.

(1) An express inter vivos trust of an interest in personalty must be in writing.
(2) A testamentary trust is not required to be in writing.
(3) Consideration is not required in the creation of an express trust.
(4) An owner of property may not make himself trustee of such property.
(5) A person who does not have legal capacity to make an inter vivos transfer of property can, nevertheless, create an express trust.
(6) An express trust can be created without the knowledge and acceptance of the trustee or the beneficiary.
(7) Resulting and constructive trusts are within the Statute of Frauds.
(8) A testamentary trust may take effect prior to the testator's death.
(9) In the absence of any evidence to the contrary, a person's deposit of his own money in a bank account in his own name as trustee for another creates a revocable trust.
(10) An express trust can not be created of property to be acquired by the party creating the trust.

12 [10]

On your paper you are to list the numbers 1 through 10. Opposite each number you are to indicate by use of the letter (a) or (b) whether the following are (a) Real property or (b) Personal property. Grade will be based on the number of correct answers. No reasons need be given.

(1) trade fixtures
(2) corporate stock

(3) mortgage on land and building
(4) wheat harvested and in the bin
(5) a certified check
(6) a wire fence enclosing a plot of land
(7) underground coal deposits
(8) a checking account in a bank
(9) a passenger elevator in an office building
(10) a ten-year-old growing tree

AUDITING

Thursday, May 15, 1952—9 a. m. to 12.30 p. m., only

Answer all questions. Credit will be allowed not only for accuracy of answer but also for technic.

1 [10]

a Prepare a short-form audit report without qualifications to be issued in a regular recurring annual audit of a commercial corporation.

b Assume that you wish to modify the previously prepared report because of a qualification as to the scope of the audit. Give an example of such a modification and show its effect on the wording of the report.

2 [15]

In connection with a recurring annual audit, you prepare a work sheet for marketable securities with column headings as shown below. Your client is not a dealer in securities. He keeps a list of the securities currently held but does not maintain an investment register.

Column No.	*Column Heading*
	Description of Security
1	(Name, interest rate, etc.)
	Beginning of Year:
2	Par value or number of shares
3	Carrying value
	Purchased and (Sold):
4	Date
5	Par value or number of shares
6	Cost
7	*Profit or (loss) on Sale*
	End of Year:
8	Par value or number of shares
9	Carrying value
10	Market value
	Interest and Dividends:
11	Accrued beginning of year
12	Purchased
13	Earned
14	Received
15	Accrued end of year

Required:

Each column is identified by a number. For each column, you are to state:

a the source(s) of the information to be entered in the column

b the principal ways in which the information should be checked in connection with your audit

3 You are assigned to the regular annual audit of a print shop with 20 employees. List the records, reports, or other data as to personnel and compensation that would be of interest to an auditor which you would expect to find in this business. Indicate briefly the purposes for which these records, reports and data would be used in an audit. [15]

4 In the audit of fixed assets an auditor has several problems. For example, he must satisfy himself that all of the owned assets are recorded. Also, he must satisfy himself that the amounts at which the assets are recorded are in accordance with accepted accounting principles.

In connection with the annual audit of the fixed assets of a medium-sized manufacturing company, state the general procedures by which the auditor can satisfy himself (*a*) that all of the owned assets are recorded and (*b*) that the recorded amounts are proper. Briefly explain how each procedure will help to satisfy the auditor and to which of the two problems it is applicable. Do not include depreciation provisions as a part of these problems. [18]

5 It is customary for an auditor to make inquiries of non-accounting officers and responsible employees. State five different things about which an auditor might make inquiries that are not primarily aimed at determining the kind and degree of internal control. For each, explain the purpose of the inquiry and the title (or duties) of the person to whom the inquiry is addressed. [15]

6 [12]

A regular annual audit includes some review of transactions and events which occurred or are recorded after the balance-sheet date. For example, it is customary to review sales returns that took place subsequent to the balance-sheet date.

In connection with the audit of each of the following, give a significant auditing procedure involving transactions or events which occurred after the balance-sheet date. Briefly state the reason for each procedure you give.

a Cash in bank

b Accounts receivable

c Merchandise inventory

d Accounts payable

7 [15]

An internal control questionnaire includes the following items. For each item, explain what is accomplished by the existence of the controls involved.

a Are costs and expenses under budgetary control?

b Is a postage meter machine used?

c Are monthly statements of account mailed to all customers?

d In reconciling bank accounts do employees of the client examine endorsements?

e Has the bank (or banks) been instructed not to cash checks payable to the company?

PRACTICAL ACCOUNTING—Part I

Wednesday, May 14, 1952—1.30 to 6 p. m., only

Consider carefully each requirement of each problem. Consider technic and neatness as carefully as mathematics.

Begin each answer on a separate answer sheet. Answers are to be written on one side of the paper only. Working papers (but not statements) may be in pencil. All other papers are to be written in ink. Write your answers legibly to insure credit to which you may be entitled. The use of a slide rule is permitted.

Solve problems 1 and 2 and either problem 3 or problem 4.

1 [12]

The board of directors of the Nelson Company authorized a $1,000,000 issue of 5% convertible 20-year bonds dated March 1, 1948. Interest is payable on March 1 and September 1 of each year. The conversion agreement provides that until March 1, 1953, each $1,000 of bonds may be converted into 6 shares of $100 par value common stock and that interest accrued to date of conversion will be paid in cash. After March 1, 1953, the bonds are convertible into 5 shares of common for each $1,000 of bonds.

The company sold the entire bond issue on June 30, 1948, at 98 and accrued interest. Deferable costs incurred in making the sale amounted to $8,230. The company

adjusts its books at the end of each month and closes them on December 31 of each year. Interest is paid as due. On February 1, 1950, a holder of $20,000 of bonds converted them into common stock.

You are to prepare entries in journal form to reflect the transactions arising out of the existence of these bonds on each of the following dates: (*a*) June 30, 1948, (*b*) September 1, 1948, (*c*) December 31, 1949 (including closing entries), (*d*) February 1, 1950, (*e*) December 31, 1950 (including closing entries).

In support of the above entries, prepare a summary analysis of the unamortized bond discount and expense account for the period to December 31, 1950.

2 [18]

A, B, C and D are partners in a firm that has been engaged in jobbing refrigerators and other household appliances. From the data below you are to prepare a summary operating statement for each six-month period of the firm's existence, an analysis of partners' capital accounts for each period and a balance sheet at December 31, 1951.

The firm started operating on January 1, 1950. At that time A and B contributed $20,000 and $30,000, respectively, as capital for the business. On July 1, 1950, C was admitted to the firm, paying in $25,000, and on January 1, 1951, D was admitted and paid in $12,000. No interest was to be allowed on the partners' investments. All partners devoted their entire effort to the business during the time they were partners and were to be compensated at the following annual rates: $8,000 each for A and B, $7,500 for C and $6,000 for D. Because of the need for increased working capital, salary withdrawals were limited to $300 per month for each partner. The partnership agreement, as finally drawn up, provided for a split of the net profit and loss after salary allowances among the partners involved for each six months in the following ratios: A—3, B—3, C—2 and D—2.

Formal books of account were not maintained but a running analysis of cash revealed the following facts:

	Six months ended			
	6-30-50	12-31-50	6-30-51	12-31-51
Collections on sales made in the six-month period ended:				
June 30, 1950	$36,600	$ 6,200	$ 4,100	$ 2,500
December 31, 1950	—	124,200	34,500	8,200
June 30, 1951	—	—	192,500	53,900
December 31, 1951	—	—	—	347,300
Payments on purchases	65,871	152,382	185,699	338,546
Rent and other fixed costs	5,698	6,550	10,891	12,141
Other expenses	2,620	14,120	22,620	23,341
Withdrawals	3,600	5,400	7,200	7,200

Unpaid customers' accounts considered collectible at December 31, 1951, by period of origin, were:

Sales made during six months ended	*Amount*
6-30-50	$ 1,600
12-31-50	3,100
6-30-51	8,600
12-31-51	26,700

A physical inventory on December 31, 1951, showed that the merchandise inventory on hand at cost, including that covered by unpaid invoices of $14,285, amounted to $83,084.

The partners have agreed:

(*a*) that "rents and other fixed costs" are to be divided equally over the four six-month periods:

(*b*) that the cost of merchandise sold during these periods may be assumed to have been 70%, 75%, 80% and 80% respectively, of sales;

(*c*) that any merchandise "loss" resulting from the application of the above amounts and percentages may be regarded as a proper addition to "other expenses";

(*d*) that "other expenses" are to be spread over the four periods in proportion to sales.

Solve either problem 3 or problem 4.

3 [20]

P Corporation acquired control of S Co. on June 30, 1949, by purchase in the market of 2,800 shares of its 4,000 issued shares of $100 par value common stock. At that time S had 500 shares of its own stock held as Treasury stock and carried at par.

On January 1, 1951, P acquired 200 additional shares from a minority stockholder. On December 31, 1951, by agreement with the minority stockholders, P acquired the 500 shares held in the treasury of S.

The Investment account of P, at cost, shows the following debits:

June 30, 1949, 2,800 shares of S	$394,800
January 1, 1951, 200 shares of S purchased from outside interests—At cost	35,000
December 31, 1951, 500 shares of S obtained from S—At cost	90,000
Total	$519,800

The accounts of S contained the following items:

Credits	*Paid-in Surplus*	*Retained Earnings*
June 30, 1949	$ 74,300	$ 43,745
Earnings 6/30 to 12/31/49	—	35,306
Earnings 1950	—	65,754
Earnings 1951	—	51,025
Premium on sale of treasury stock	40,000	—
Total	$114,300	$195,830
Debits		
Dividends Paid 12/1/49	—	$ 35,000
Dividends Paid 12/5/50	—	35,000
Dividends Paid 12/15/51	—	40,000
Total	—	$110,000
Balance 12/31/51	$114,300	$ 85,830

You are to prepare the eliminating entries necessary for preparation of consolidated balance sheets as of June 30, 1949, and as of December 31, 1951, after acquistiion of the treasury stock. Show supporting computations in good form and identify all balances not eliminated from the Investment, Stock, Paid-in Surplus and Retained Earnings accounts.

4 [20]

The R Manufacturing Company estimates its cost for a unit of product X to consist of the following:

Material—5 lb @ $1.22 per lb
Labor—7 hours @ $1.30 per hour

Overhead is applied on a direct labor basis and need not be considered in this problem.

The company takes the raw materials purchased into Inventory of Raw Materials at $1.22 per pound, recording any difference between that price and actual purchase cost in a Price Variation-Materials account. The actual raw material used is issued to production at $1.22 per pound. The material cost and the actual direct labor cost for the month are recorded in separate work-in-process accounts. Finished goods inventory is debited and these process accounts are credited with the estimated cost of completed units. At the end of the month the finished goods account and the work-in-process accounts are adjusted to actual cost by spreading the differences between actual costs and estimated costs over the accounts in proportion to the amounts of estimated costs applicable to each of the accounts. Material price variation is spread over Inventory of Raw Materials, Work-in-Process and Finished Goods in the same manner as other variations, but the amount applicable to Inventory of Raw Materials is left in the Variation account.

Account balances after adjustment for March 31, but before adjustment to actual costs for April 30, were as follows:

Account	*Debit Balances 3/31/52 After Adjustment*	*Debit Balances 4/30/52 Before Adjustment*
Inventory of Raw Materials	$10,485.90	$10,673.78
Price Variation—Materials	723.55	973.28
Work-in-Process—Materials	770.80	1,091.90
Work-in-Process—Labor	731.15	758.94

The 3/31/52 balance of Work-in-Process-Materials includes $49.78 of Price Variation.

Status of the work in process was as follows:

	March 31, 1952		*April 30, 1952*	
	Units	*% Completed*	*Units*	*% Completed*
Materials	60	50	50	30
Materials	80	90	100	75
Labor	60	25	50	10
Labor	80	80	100	60

During the month of April 1952, 510 units of product X were completed and transferred to finished goods.

You are to set up skeleton ledger accounts for all of the accounts affected by these transactions and prepare and post the adjustments necessary for the company as of the end of April 1952.

PRACTICAL ACCOUNTING—Part II

Thursday, May 15, 1952—1.30 to 6 p. m., only

Solve all problems.

1 [15]

The following items relate to federal income taxes. List the identifying letter and number for each item and opposite each number give the answer which you believe to be correct. No reasons need be given to support your answer. Your grade will be based on the number of correct answers you submit.

a The following statements are to be answered by deciding whether the statement is generally true or false. If the statement is true, enter (a) on your answer sheet; if the statement is false, enter (b) on your answer sheet.

(1) Husband and wife live together, husband entirely supporting spouse. Wife dies during taxable year. Husband may not file a joint return and claim an exemption for his wife since she was not alive for the entire taxable year. (a) True (b) False

(2) Taxpayer files a joint return. He supports his wife's cousin. He may not claim his wife's cousin as a dependent. (a) True (b) False

(3) T purchased annuity in 1948, paying $60,000, by terms of which he is to receive $5,000 annually, commencing in 1951. T will be required to report gross income of $3,200 for 1951 in respect to this annuity. (a) True (b) False

(4) T is paid part of his 1951 salary in 50 shares of X Corporation stock which has a par value of $100 per share. At date of receipt the stock is worth $60 per share. T must report $5,000 as income in respect to the X Corporation stock. (a) True (b) False

(5) It is mandatory for the taxpayer to amortize the premium paid on wholly tax-exempt municipal bonds. (a) True (b) False

(6) A non-business bad debt is treated as a short-term capital loss in the year it becomes worthless. (a) True (b) False

(7) The taxpayer, an individual who is on the accrual basis, signs a pledge in 1951 to contribute $500 in 1952 to the American Red Cross. This transaction constitutes an allowable deduction for the year 1951. (a) True (b) False

(8) If the taxpayer sells securities at a profit and within 30 days thereafter acquires an equivalent amount of substantially identical securities, no gain is recognized. (a) True (b) False

(9) Hotel expenses incurred by an employed salesman while away from home on business are deductible for the purpose of determining adjusted gross income. (a) True (b) False

(10) The taxpayer, a married man with two dependents, receives $4,800 in salary, subject to withholding, and $800 in dividends. He is required to file a declaration of estimated tax. (a) True (b) False

(11) The taxpayer furnished 80% of the support of his sister who is married and who filed a joint return with her husband. The taxpayer may not claim his sister as a dependent. (a) True (b) False

(12) X owns securities which yield $200 per year in taxable interest. He has directed that the interest be paid to his son. The interest income is taxable to X. (a) True (b) False

b The following are to be answered by indicating the letter that identifies the correct answer for each situation.

(1) T, a calendar-year taxpayer who keeps his records on the accrual basis, receives on November 1, 1951, $3,600 covering rent for a three-year period, commencing January 1, 1952, on a store which he owns. For the year 1951, T should report as gross income, with respect to the rent received: (a) 0 (b) $200 (c) $1,200 (d) $3,600 (e) some other amount

(2) X, an infant 14 years old, earns $400 during the taxable year by selling newspapers. This constitutes his gross income for the year for federal income-tax purposes.

(a) X is required to file a tax return.

(b) X need not file a tax return but his father, Y, must include on his return the $400 earned by X.

(c) X need not file a tax return, and his father need not include on his return the $400 earned by X.

(3) An unmarried taxpayer, aged 32, with two dependents, has adjusted gross income of $4,000. During the current taxable year, he incurred, but did not pay, hospital expenses of $350. He paid incidental medical expenses of $25. What amount is deductible as medical expenses? (a) $175 (b) 0 (c) $150 (d) $375 (e) answer other than indicated

(4) On July 1, 1949, Jones leased land and buildings to the ABC Company. The company made improvements amounting to $2,000 on the buildings. Jones had purchased the land and buildings for $20,000 on January 1, 1949, and was depreciating the buildings at 5% each year. On July 1, 1951, Jones repossessed the property which at that time had a fair market value of $23,000. What gain must Jones report on repossession? (a) $5,500 (b) $3,500 (c) $2,000 (d) 0 (e) some other amount.

c Jackson, who owns and operates a business as an individual proprietor, had the following transactions during the taxable year. For each transaction you are to state (*a*) the amount of recognized gain or loss, and (*b*) the tax basis of the new asset.

(1) He exchanged a machine having an adjusted basis of $4,000 for a similar machine worth $2,200 and received $1,200 in cash.

(2) He exchanged a truck having an adjusted basis of $2,200 for a truck having a fair market value of $1,800 and received $700 cash on the trade.

(3) He exchanged a pleasure car for which he had paid $1,500 and gave $600 cash for a new pleasure car listed at $1,900. His old car had a cash sale value of $1,400.

(4) He had one machine destroyed by fire. He collected $10,500 insurance and immediately purchased a similar machine for $12,000. The machine destroyed had an adjusted basis of $9,600.

(5) He sold for $4,500 a machine which had an adjusted basis of $7,500 and immediately purchased a similar machine, using the proceeds of the sale and $7,500 additional cash.

d Indicate whether or not the following items received during 1951 are includible in gross income of recipient for the year 1951 by the use of the following letters: (a) Yes (b) No

(1) Amount received from an employer as severance pay.

(2) Pension of $1,500 paid voluntarily by a company to a retired employee. (Employee has contributed nothing toward this pension.)

(3) Dividends received by the insured on a life insurance policy.

(4) Amount received as a result of a suit for personal injuries.

(5) Compensation for personal injuries sustained under workmen's compensation acts.

(6) Unemployment insurance benefits paid by a state.

(7) $800 insurance premiums paid by corporation on life of T, its president, where T is permitted to name the beneficiary.

(8) T is insolvent both prior to and subsequent to forgiveness of a $5,000 debt which T owed L.

(9) $1,000 market value, at date of receipt, of exempt municipal securities received by T as dividend on X Company stock which he owned.

(10) Supper money received by T and deducted as "Miscellaneous Expenses" in the employer's tax return.

(11) Reward of $1,000 received by T for prevention of a bank robbery.

(12) Interest of $50 received on a Postal Savings Account which T had deposited in February of 1940.

2 [10]

The Metal Products Co. manufactures three different models of a single product. From the following data you are to prepare a schedule, supported by computations, showing the sales quantity and sales dollar figure for each model necessary to enable the company to cover its non-variable costs.

Model Number	*Annual Sales Budget (Units)*	*Budgeted Unit Sales Price*	*Budgeted Sales Allowances for a Year*
100	30,000	$15.00	$1,260
200	16,000	18.00	480
300	10,000	25.00	410

1952 Estimates

		Over-all Estimated Cost Per Unit		
Model Number	*Quantity Budgeted for Production*	*Total*	*Variable Cost*	*Non-variable Cost*
100	30,500	$15.072	$ 9.871	$5.201
200	15,000	17.335	10.250	7.085
300	10,000	23.756	15.436	8.320

3 [25]

M and N form a partnership in July 1951 to sell a product for which they have an exclusive franchise covering 20 counties of a state. In order to fully exploit the market, they establish a branch in one town. This branch is operated by a manager. The partnership did not employ a bookkeeper since N was expected to keep such records as were needed. However, after operating until October 31, 1951, the partners agreed that N did not have sufficient time available to keep the necessary records. Jones and Johnson were engaged to correct the present records and prepare financial statements as of October 31 after which the business expected to employ a bookkeeper.

There are three models of the product that are handled by the firm. Sales price and cost are as follows:

	Sales Price	*Cost to M and N*
Model X	$290	$174
Model Y	245	147
Model Z	195	117

Salesmen are employed on a commission basis. Advances are made to several of the salesmen that are to be offset against future commissions. The firm had to finance some of its inventory by borrowing from a local bank against warehouse receipts. Installment notes accepted in settlement of sales are discounted at their bank on a recourse basis. Interest and finance charges are included in the face amount of the notes.

The branch was opened August 1. Shipments of the product are made direct from the manufacturer to the branch, but billed to the home office. The home office bills the branch at 20% above cost for such merchandise. The branch is to have a working fund of $2,500 operated on an imprest basis. Cash received from branch sales is deposited in a separate bank account subject to withdrawal only by one of the partners. Weekly reports are sent in by the branch manager.

The books set up include a Cash Receipts Book, a Cash Disbursement Book and a General Journal in addition to the General Ledger. No postings have been made in the ledger. The accountant, therefore, summarized the entries in the cash books and journal and prepared the following summaries prior to posting to ledger accounts:

Cash Receipts Book Summary

	Debit	*Credit*
Cash—Home office bank	$56,397	
Cash—Branch bank	6,875	$ 5,000
Installment notes		17,439
		27,780
Home office sales		10,700
Branch		6,875
Interest and finance charges	1,744	
	2,778	

Cash Disbursement Book Summary

Cash—Home office bank		78,356
Purchases	17,910	
Branch	10,206	
Bank loans	25,000	
Interest on loans	240	
Sundry Columns		
Petty cash—Branch	2,500	
Partners' drawings	3,775	
Sales commissions	5,105	
Warehouse and delivery	1,414	
Trucks	5,994	
Taxes withheld		410
Miscellaneous selling expense	3,069	
General and administrative expense	3,553	

General Journal Summary

	Debit	*Credit*
Cash	$30,000	
Branch	22,392	
M's Investment		$15,000
N's Investment		15,000
Purchases		18,660
Profit on branch		3,732

Investigation of the transactions revealed the following additional information:

(1) The purchases entered in the cash book included only the cash paid from the bank account. Bank loans were obtained for the remaining cost of purchases but not recorded on the books. Purchases during the period were as follows:

	For Home Office		*Branch*	
Model	*No.*	*Amount*	*No.*	*Amount*
X	50	$ 8,700	60	$10,440
Y	100	14,700	40	5,880
Z	50	5,850	20	2,340

A general journal entry was made charging the branch with the purchases at 20% above cost. This 20% was credited to Profit on Branch.

(2) Home office sales were:

Model X—42 units for $12,180
Model Y—70 units for $17,150
Model Z—36 units for $ 7,020

The $10,700 of cash received from home office sales was entered in the cash book. Installment notes having a face amount of $28,520 which were accepted for $25,650 of home office sales were not recorded when received. Proceeds of discounting installment notes taken by the home office and by the branch were recorded in the cash book. Face amount of $27,780 of home office notes were sold to the bank at a discount of $2,778. The remaining notes discounted were received from the branch.

(3) Depreciation on the trucks should be $333 for the period with $130 of that amount chargeable to branch expense for truck used by branch.

(4) Sales commissions earned by home office salesmen amounted to $4,350. Only $4,100 of this amount was subject to offset against cash advances made of $5,105, leaving $250 due to certain salesmen.

(5) Unpaid expenses of the office are as follows:

Delivery expense	$ 96
Miscellaneous selling expense	212
General expense	90

(6) Information obtained from the branch shows the following accounts:

	Debit	*Credit*
Petty cash fund	$ 2,500	
Purchases	22,392	$ 1,044
Sales		22,550
Sales commission expense	2,955	
Installment notes	17,439	17,439
Interest and finance income		1,764
Deposits for home office	6,875	
Remittances from home office		12,706
Home office	18,483	22,392
Rent of office and equipment	540	
Rent of warehouse	300	
Delivery expense	375	
Taxes withheld		431
Miscellaneous selling expense	5,416	
General and administrative expense	1,051	

Other than the inventory account and the asset and liability accounts included above, it is the policy of the firm to have only income and expense accounts included in the branch accounts.

The inventory at the end of the month at billing price to branch was $5,112. The credit to purchases was for 5 of Model X returned to the factory for credit because they were defective and, therefore, charged to home office. All installment notes have been transferred to the home office. The Remittances from Home Office include the original cash fund and all expenses recorded. However, the actual cash in the imprest fund is only $2,037 because of unreimbused expenses of $87 sales commissions, $302 of office salaries and $74 of miscellaneous general expense. Unpaid advertising of $185 has not been recorded. Inventory on hand at branch consists of 10 of Model X, 6 of Model Y and 14 of Model Z.

Required:

a Prepare a work sheet for the Home Office accounts, with columns for Transactions, Corrections and Adjustments, Profit and Loss, and Balance Sheet.

b Prepare a work sheet for the Branch accounts, with columns for Trial Balance, Corrections and Adjustments, Profit and Loss, and Balance Sheet.

c Prepare a reconciliation of the reciprocal accounts on the books of the Home Office and of the Branch, *setting forth the inter-office transactions.*

New York State Tax Forum

Conducted by Benjamin Harrow, C.P.A.

Sixth International Congress on Accounting

This important event was held at the Royal Festival Hall in London from June 16th to June 20th. Thirty-six countries were represented. Your editor was present as one of the delegates of our Society. The accountants of England, Scotland and Ireland were our gracious hosts and we certainly received a royal welcome. Special services were held for the delegates in Westminster Abbey and Westminster Cathedral. One of the highlights of the Congress was the presence of George O. May who was a delegate at the first Congress in 1904 and who has attended all six Congresses.

The sessions opened with an address of welcome by the President of the Congress, Sir Harold Jowitt. He spoke of the important role played by the accountant in the modern world, characterized by changing monetary values, heavy taxation and capital development as it is affected by taxation and changes in the value of money. He spoke to more than 2,500 members of the Congress, of whom 668 came from accountancy bodies overseas. Sir Harold anticipated much of the discussion when he referred to the purpose of final accounts, "namely to show whether and to what extent a surplus or a deficit has accrued over a period of time, and to show the financial position at the end of that time." While this purpose sounds easy, it is beset with difficulties since different people have different views as to what is "true and fair" and the desired ends are often conflicting.

The chief difficulty seems to be that accounts are being used to serve many purposes, not all of which can be reflected in the same document. Sir Harold referred to the diversified and conflicting interests of proprietors, temporary investors, wage earners, economists, tax collectors and even politicians. A single form of accounts is thus subject to much strain in attempting to satisfy all these interests. Inflation and high taxation have added to the difficulty. He also noted that no other profession has increased numerically as ours has over the past fifty years. There has never been so great a demand for our services, not only in the field of public accounting, but also in government and industry. Sir Harold concluded his address with the hope that qualified accountants throughout the world would have "a material influence towards right thinking on all those financial and economic problems which are normally at the root of international disputes and wars."

Benjamin Harrow, C.P.A., has been a member of our Society since 1928. He is a Professor of Law at St. John's University.

Mr. Harrow has been a member of the American Institute of Accountants since 1922 and is a member of the New York Bar. He is now serving as one of the Vice Presidents of the Society and is also on the Society's Committee on Federal Taxation, and is past Chairman of its Committee on State Taxation. He is also a member of the Institute's Committee on Federal Taxation and its Council.

Mr. Harrow is engaged in practice as a certified public accountant and attorney in his own office in New York City.

Fluctuating Price Levels in Relation to Accounts

The first business session was probably the most controversial. Eight papers on this subject had previously been prepared and sent to the delegates. A rapporteur summarized the papers. Fundamentally they dealt with money as a means of measurement, the purpose of accounts, and the effect of permanent changes in money values. In times of rising prices existing accounting conventions do not provide adequately for the replacement of assets. Profits are overstated, with the result that taxation and dividends are excessive and the real capital of a business is depleted. The principal changes suggested are the computation of depreciation and the valuation of inventories on the basis of replacement cost rather than historical cost. Some of the speakers felt that replacement cost is impracticable and unrealistic. Historical cost is well established and understood and accounting should be objective and factual. In the United States the use of the LIFO inventory method has become an accepted accounting principle and approaches the principle of determining costs on the basis of replacement values. However, for balance sheet purposes LIFO is considered as inappropriate.

In the discussion which followed the summary of the prepared papers, Professor Scott, of the United States, said that "the nature of the conflict is essentially one between tradition and the growing science of accounting. The doctrine of historical cost which represents tradition is a defensive, restrictive device." He felt that in the course of time we will abandon the doctrine of historical cost. The discussion was summed up by C. Percy Barrowcliff, Vice President of the Congress, who said that accountants must recognize that business was a continuing enterprise and they must apply that fact in practice by preserving at least the physical assets of a business. As he put it, "if we are content to allow exhaustion of the physical assets over a period of years, then it simply means that the concern will completely go out of business unless fresh capital is produced." To preserve the physical assets intact, the earnings of a business must be measured correctly. He felt that it was not merely a matter of reducing taxes by getting a larger depreciation deduction based upon replacement values.

Accounting Requirements for Issues of Capital

This was the subject of the second session. Five papers had been submitted previously to the delegates. The rapporteur summarized the papers which he said distinguished between two main functions of the accountant, to provide information to the prospective investor and to advise upon financial policy and prospective earnings. There was no formal paper by an American, which was unfortunate because the function of the accountant under the Securities Exchange Act merited extended presentation. Mr. Anson Herrick, of the United States, felt that one of the responsibilities of the accountant is to take the lead in the establishment of adequate regulations relating to the manner of presentation of information provided for prospective investors. He was not thinking of the legal requirements under acts similar to the Securities Exchange Act nor to the technical requirements set by accounting organizations for proper audit procedure, but to the moral responsibility. One delegate noted the growth in importance of our profession, in that the public and governments recognize the importance of the certificate issued by firms of accountants in connection with information relative to capital issues. One American delegate made a plea for standardization of accounting terminology for all countries. In summarizing the afternoon discussion, Mr. MacDonald of Scotland said that the potential investor was interested in the total amount of tax which was likely to be paid by a

business. In the development of public information in relation to accountants' reports, there has been a drive by the financial or governmental authorities to establish accounting standards for the protection of public investors. Beyond this there has developed the necessity to supply information that will enable investors to assess the real merit of what is offered. Accountants are more and more called upon to give advice to clients on their investments.

The Accountant in Industry

Those of us who are in public practice may not be fully aware of the extent of the development of management accounting in recent years. The essence of management accounting is planning ahead so that the actual achievement of a business may be measured against predetermined standards. The functions of the accountant in industry comprise the executive function and the informative function. It is up to the accountant to tell management what has happened and whether the planning has been effective. The classification of expenditures and budget control are essential elements. Mr. Clinton Bennett was of the opinion that accounting information is as much needed by the medium and small-sized business as by the large industrial units. Management must have monthly statements of accounts. Of course, the accountant who does go into industry will acquire an important status generally in countries where industrial units are large. Cost accounting looms large to the accountant who goes into private industry. It was the opinion of one speaker that facilities are limited for practical and theoretical training in management accounting. Several of the formal papers made the observation that one of the most valuable services which the accountant can render is aid to small businesses. The health and well-being of the small business is essential to the survival of the system of free enterprise. One speaker argued for a shortening of the accounting period. Instead of waiting until the end of the year to discover the inefficiencies that have occurred, the business man should get information at intervals of not more than one month. A Finnish delegate noted that in his country a new act on bookkeeping was passed in 1945, stipulating that anybody carrying out industrial activities on a factory scale should, in addition to double-entry bookkeeping, carry out production cost accounting. A British accountant said that since the war everything in accountancy has been overshadowed by management accounting. The new look in accountancy he said is to make the accountant in industry a technical executive whose function is to provide management with data, statistics and forecasts for the formulation of policy. One speaker warned that the industrial accountant must not lock himself up in an ivory tower. He must take his eyes from the text books, schedules and calculating machines and go into the factory. There he will get the points of view of the people themselves. One speaker criticized the tendency to turn out both industrial and professional accountants from the same mold. Our own C. Oliver Wellington made the observation that the value of cost accounting lay in its contribution to the control of a concern. Management should be given frequent reports of the more important operations so that losses might be detected quickly. In the summing up, the statement was made that the accountant was the only person able to present an over-all picture of an undertaking.

The Accountant in Practice and in Public Service

In countries outside the United States the accountant occupies an important position in public service. The significance of this fact was contrasted with the functions of the accountant in practice. In practice the independence of the accountant is paramount. In public service the accountant is

concerned with management as well as advising and auditing functions. Coleman Andrews, of the American Institute of Accountants, pointed out that, for the accountant in practice, taxation services were increasing in importance. He referred briefly to our lawyer-accountant controversy by saying that a tentative agreement had been worked out between accountants and lawyers to divide taxation work. One of the papers submitted mentioned the intelligibility of financial data. It was important he thought that accounts should be understandable by the uninitiated, especially in the fundamental problem of the determination of profit.

Reference was made to the work of professional accounting organizations and it was suggested that some attention should be given to the difficulty practicing accountants are experiencing in providing capital for a sizable practice and in making adequate provision for their own retirement. A Canadian delegate remarked that excessive taxation constituted a direct attack on the independence of the accountant. There was some criticism of countries whose laws permit people "not knowing a debit from a credit to form themselves into a company holding itself out as an association of qualified accountants." Apparently accountants in other countries are concerned with unqualified practitioners who are not governed by any professional code of conduct, who obtain clients by advertising or work for fees that would be unremunerative to a qualified practitioner. While they are but a minor annoyance to large firms, they do hurt the small firm or sole practitioner. One delegate emphasized the superiority of a continuous audit.

Another delegate commented on the growth of specialization in the profession. He felt that small accountancy firms were reluctant to call in the services of these specialists for fear of losing the job. One delegate spoke of the desirability of the practicing accountant holding company directorships. To what extent this would conflict with the required independence of the accountant is another problem.

The difficulties of the small practitioner received the attention of one of the delegates. He felt that it was up to those in the larger practices to assist the smaller men in every way they can.

The Incidence of Taxation

The final sessions were devoted to the all important subject of taxation. The rapporteur was our own Percival N. Brundage and one of the excellent papers submitted was by our own Tom J. Green. It was the general opinion that redistribution of wealth is a conscious purpose of taxation and the heaviest tax burden is borne by those who have the largest incomes. All the speakers felt that taxes are too numerous, too complex and too burdensome. As Percy Brundage put it, "excessively high rates are stifling business growth, deadening incentive, discouraging savings and encouraging extravagance in deductible expenditures. Tax evasion is growing. Tax avoidance is universal. The tax aspects of a transaction have become the most important factor in influencing many business decisions."

Adam Smith laid down certain principles of taxation. Several of the papers tested our modern tax systems by these rules and found them wanting. Adam Smith's first principle was assessment according to ability to pay. This principle is widely followed in all countries. It has resulted in greater tax evasions and the discovery of more loopholes.

Certainty of determination is the second principle. Due to the extreme complications of the law our tax systems have fallen down badly. In the United States, determination of the tax is made uncertain by Treasury regulations, voluminous technical provisions in the law, administrative rulings and court decisions. Final tax liability is frequently decided by compromise.

The third principle is convenience of

payment. In the United States, the individual taxpayer pays his tax currently. Corporations will soon be paying their taxes within six months after the end of the fiscal year.

The fourth principle is economy of operations. In this respect the tremendous amount of time required to compute the correct tax liability throws a heavy burden upon all taxpayers. Large corporations must maintain tax departments at a cost of hundreds of thousands of dollars. One delegate stressed the fact that the total yield decreases as taxes become excessive. Incentives for expansion of industry and the launching of new enterprises diminish under the impact of high taxes.

Another delegate argued that the book profit of corporations is too high under present fluctuating price levels. This should be corrected either by allowing increased depreciation deductions based upon current replacement values or taxing at lower rates profits retained up to a certain amount if invested in plant and equipment.

One speaker argued for relief from double taxation, where income is taxed in the country of origin and also in the country of residence.

Sixth International Congress— Social Program

One cannot talk about the Congress without some comment on the social events. We were guests of the sponsoring bodies and our gracious hosts prepared a program for us that we shall never forget. The banquet at Guildhall was a memorable occasion. The Archbishop of Canterbury paid a fine tribute to the accountant. "The qualified accountant," he said, "gives a demonstration of the true account of freedom in which he is always the servant of the facts and cannot manipulate facts to suit his own use." Other speakers were the Lord Mayor of London and Lord Radcliffe.

A small group of us were entertained at a luncheon as guests of the Institute of Chartered Accountants in Ireland. The warmth and geniality of our reception immediately put us at ease and made it easy for us quickly to become an intimate part of the Congress.

A government reception, cocktail parties, theatre parties and the Congress Ball, all these filled up any spare hours we might otherwise have had. American delegates were also guests of Arthur Foye at a cocktail party preceding the opening of the Congress. One entire day was devoted to sightseeing and there is much to see and treasure in England. The entire experience was quite thrilling.

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Tax Opinion

This is the title of a report on a survey conducted in 1951 by the New York State Tax Commission to determine the opinions on important tax issues of selected tax authorities. It is based upon a comprehensive questionnaire mailed to a group of experts which included professors, lawyers, accountants, government officials, business officials and representatives of taxpayers groups. Replies were received from 308 correspondents residing in 47 states and the District of Columbia. The replies to the questionnaire were carefully analyzed, and, as Spencer Bates says in the report, the material constitutes a vast and useful reservoir of basic information. Some of the results should be of special interest to our members.

Personal Income Tax

To the question, Should wages, salaries and professional income be taxed at lower rates than income from property, out of 284 replies, 206 said no. It is significant that out of 28 accountants, 16 said yes and 12 no.

Should income from all future issues of government securities be fully taxable? Out of 265 replies, 216 thought that such income should be subject to tax both by the federal and state governments; 49 said no.

Should dividends be taxed to the stockholders? Out of 275 replies, 249 said yes as to cash dividends, and 26 said no. 159 were in favor of taxing such dividends at the full rate and 87 at a preferential rate. As to stock dividends, 247 out of 271 favored the taxation of such dividends.

Should net capital gains be taxed? Yes said 233; no said 44.

An overwhelming majority of replies opposed a Constitutional limitation on combined normal and surtax rates (192 to 93). The accountants were about evenly divided: 15 no and 13 yes.

The replies were about even on favoring withholding from residents and nonresidents under state personal income taxes (167 yes; 110 no).

There is much sentiment for averaging income taxes (yes 245; no 31). Suggestions ran from a 2 year carry-back and 2 year carry-forward to only a carry-forward of as much as six years. There was some sentiment for a moving average covering anywhere from two years to five years.

Business Taxation

Should net income taxes apply to corporate and unincorporated business? Out of 278 replies, 211 answered yes to this question, and 137 were of the opinion that the rate should be the same.

Do you favor taxation of corporate dividends at the source with a credit to stockholders to avoid double taxation? Out of 274 replies, 193 answered yes.

Should Federal corporation net income taxes be graduated? Out of 267 replies, 170 answered yes, and 31 were of the opinion that the law should provide more brackets with the maximum changed.

Should the taxation of corporations on net income be confined to the Federal government with a share of the proceeds paid to the states in order to avoid complications of allocation at the state level? Out of 274 replies 179 said no. 211 out of 279 favored taxing excess profits of corporations. 178 would do so only during war or defense emergencies; only 46 would favor such a tax during a peacetime inflationary period; and only 33 as a part of the normal corporation tax structure.

140 out of 268 favored the taxation of undistributed corporate profits separately. 116 out of 269 were in favor of permitting a corporate taxpayer to determine freely rates of depreciation; 107 out of 259 would do the same for rates of obsolescence; and 84 out of 256 would apply such a principle to depletion.

Death and Gift Taxes

There was considerable sentiment for combining the 1926 and the 1932 federal estate tax rates as amended (198 to 23). Sentiment also favored a percentage credit for state taxes (135 to 5). A sizable majority of the replies favored no constitutional limitation on the maximum federal estate tax rate (169 to 66).

Do you favor state surtaxes on the federal death and gift tax basis in lieu of separate state taxes? Opinion was almost evenly divided (yes 103; no 120).

Notes on the New York State Unemployment Insurance Law

Conducted by Samuel S. Ress

Employment in New York and New Jersey

A claimant worked in New York for an employer who operated retail stores in New York and New Jersey. She accepted a promotion from her employer to a job as assistant manager in his Paterson, New Jersey, store and worked there from February to October, 1948, when she was given other employment by her employer in New York. The issue in this case was whether claimant's work in New Jersey constituted "employment" under New York Law for the purpose of computing benefits for the claimant.

The Appeal Board held in case number 26,873-51, that the work in New Jersey was "employment." The Industrial Commissioner appealed. The Appellate Division of the New York State Supreme Court, Third Department, reversed the decision of the Appeal Board and held that the work in New Jersey was not "employment."[1] The court stated that Section 511, subdivision 2, of the Unemployment Insurance Law provides that the term "employed" includes all the services performed within and without New York if the service is "localized" in New York.

> ". . . By localized in New York it is meant that the service is either performed entirely here, or if performed also elsewhere 'that performed without the state is incidental to that performed within the state'. . . . ". . . it is clear that the service was not localized in New York but in New Jersey where contributions were paid by the employer. . . ."

Samuel S. Ress has been an Associate Member of our Society since 1936, and is also a member of the Bar. He has specialized in the payroll tax field since the inception of this type of legislation in 1936.

Dr. Ress is a member of the Society's Committees on Clothing Manufacturing Accounting, on Labor and Management, and on State Taxation.

Simultaneous Employment by Two Employers

The Appellate Division of the Supreme Court of the State of New York decided that the Appeal Board was correct in holding that Employer A was liable for additional contributions and that Employer B is entitled to a credit as a result of the reallocation of the wages of certain joint employees.[2]

The facts in the case at bar involved certain officers and administrative employees who performed services for both corporations. Employer B operated trolley cars and Employer A operated buses. Employer B owned all the stock of Employer A and financed its organization. Each had the same officers but the directors were not the same. Both corporations occupied the same building but each kept its own books, separate bank accounts, filed separate Unemployment Insurance returns and generally operated as a separate entity. Each month Employer B charged Employer A with a share of

[1] *In the Matter of the Claim for Benefits under Article 18 of the Labor Law made by Ida Krant, respondent,*—App. Div. ——, decided June 13, 1952.

[2] *In the Matter of the Liability for Unemployment Insurance Contributions under Article 18 of the Labor Law of Capitol District Transportation Co., Inc., and United Traction Co., appellants,*—App. Div. ——, decided June 13, 1952.

administrative expenses for services performed by certain administrative employees who were not listed by Employer A as employees for Unemployment Insurance purposes. Employer A's books reflected payments made to Employer B for their services. The Court held:

> ". . . Since these employees performed services for both, they were employees of A as well as of B. They were joint employees of both. (*Matter of De Noyer* v. *Cavanaugh*, 221 N. Y. 273; *Matter of Vivienne Miller*, 260 App. Div. 888.) This is not a case of one corporation contracting to manage another as in *Matter of Fulton Ship Operators, P. & I. Inc.*, 273 App. Div. 614) . . ."

Principal Stockholders

The recent amendment to the New York State Unemployment Insurance Law regarding the tax status of compensation paid to principal stockholders whose compensation is also taxable for Federal Unemployment Tax purposes, has been interpreted by the New York State Unemployment Insurance Division to be retroactively effective to January 1, 1952. This compensation should not be reported in the quarterly New York returns for 1952, but must be reported annually in the month of January, 1953, covering the entire amount paid to such principal stockholders, along with that paid part-time student workers, golf caddies and for dismissal pay.

1952 Social Security Act Amendments

The new Social Security Law (H. R. 7800) was signed by the President. It raises the benefits of all beneficiaries and liberalizes the formula for computing future benefits. It permits recomputation of benefits for self-employed persons who file in 1952 and gives servicemen wage credits during the present emergency. It permits examination of disabled persons under special Federal-State agreements and provides for the freezing of wage credits during disability. It also provides that a beneficiary under age 75 can earn $75 per month without losing his Social Security benefits for the month. Under the old law a beneficiary under age 75 could earn $50 in wages any month and still receive his Social Security benefits for the month. Self-employed persons are also permitted to earn an average of $75 a month without losing benefits for that year.

The increased benefits for those now receiving benefits based on earnings from 1937 on, are determined by a new table included in the law. The amount of increase would be the larger of $5.00 or 12½ percent of the present amount. Increases would range from $5.00 per month to $8.60 a month.

Benefits of dependents or survivors of a person whose primary insurance amount is computed under the conversion table would be increased by either 12½% of the present benefits or the appropriate proportion of $5.00.

Benefits of future recipients, i.e., those whose benefits are based upon a minimum of six quarters of coverage after 1950 would be accomplished by by using a revised formula in the law. The old law provides for 50% of the first $100 of average monthly wage or self employment income plus 15% of the next $200. The new law provides for 55% of the first $100 of average monthly wage or self-employment income, plus 15% of the next $200. The maximum primary insurance amount would go up to $85, instead of the present $80, with proportionate increases for dependents' and survivors' benefits. The maximum limitation on family benefits would be raised from $150.00 to $168.75, with the present minimum for individuals raised to $25 from $20 per month.

In recomputing benefits for self-employed, the new law would permit 1952 earnings to be reflected in a recomputation made after the close of the taxable year. A supplemental payment would make the benefit increase retroactive. When determining average monthly income under the present law, the numer-

ator of the fraction would be the amount of income earned in 1951 whereas the denominator would be the minimum 18 months described in the law. The average monthly income could be no more than ⅔ of what it actually was.

Servicemen will be given credit for $160 in wages per month for each month of active military or naval service from World War II to the end of 1953.

A change in benefit computation procedure from the present provision which requires that the wages of the two quarters preceeding the quarter in which a worker files for retirement or dies be disregarded, although the denominator of the computation fraction must be not less than the minimum of 18 months. The old law permitted recomputation after 6 months and a supplemental check to make up the difference. The new law will permit on the original computation of benefits the use of all covered wages up to the quarter of death or filing of the retirement application.

AN ADIRONDACK VIEW

Words and their different meanings lead folks into strange and interesting paths—especially the meanings that are not in the dictionary. This is not a learned treatise on semantics, that is a serious subject; when we see this word it sounds like a course in a theological seminary—perhaps it is. Now here are some curbstone meanings that you will perhaps meet:

Young man—any man younger than you.

Boy—if you are over 60, a man under 35.

Old man—if you are under 40, a man over 50; if you are over 60, a man older than you—but not you.

Surplus—extra cash in the bank that should be paid to stockholders; or paid in wage raises—if you are an employee.

Profits—just plain extra cash, too little to suit the stockholders, much too large in the eyes of everybody else.

And so the list could go on. . . Of course none of us ever use such odd meanings for these words, or any other words. But other folks do!

Leonard Houghton, C.P.A.
Adirondack "Chapter."

Office and Staff Management

A forum for the exchange of views and information on all aspects of the administration of an accounting practice.

Conducted by MAX BLOCK, C.P.A.

Mailing Pamphlets to Clients

A gratuitous service to clients which can be of considerable help to them, and thereby constitute an important goodwill builder, is that of sending them pamphlets that deal with their business. Such pamphlets can be obtained from various governmental agencies, such as the Department of Commerce, The Office of Technical Services, and the Superintendent of Documents at Washington, D. C.

Accountants should subscribe to the agencies' catalogues and be registered on their mailing lists as a means of keeping informed of new data released. When a pamphlet is listed which should interest a particular client, send for it and then mail it to that client. This will be regarded as a most considerate action and a manifestation of the accountant's personal interest.

The policy can be extended to pamphlets, articles, and even books from other than government sources, so long as they may be useful to clients. Even if some expense is incurred, it will probably be a good investment.

There is hardly a business, particularly those in the small business field, that has not been surveyed and studied. The findings, and helpful ideas, are either distributed free of charge or at insignificant prices. Every aspect of business—problems of management, manufacturing, distributing, labor relations, new products and processes, and other pertinent subjects—is covered.

MAX BLOCK, C.P.A. (N.Y., Pa.) is a Director of the New York State Society of Certified Public Accountants and has been the chairman of the Society's Committee on Administration of Accountants' Practice. He is a member of the firm of Anchin, Block & Anchin.

Clients' Mailing Lists

There are occasions when an accounting firm desires to circularize a segment of its clientele. The subject may concern only a limited group such as, for example, individual taxpayers, corporations, partnerships, companies subject to different government controls, manufacturers, distributors, etc. For this purpose mailing lists are required. It would not be practical to have a mailing list for each group and the presence of some names on more than one list would swell the aggregate number of names. Changes in clients and in classifications would be somewhat of a problem.

However, a single, centralized mailing list can be made to serve the purpose very effectively. This can be accomplished by the use of cards which would have a key-punch border. The client's name, address, and other desired data appear on the card. On the border there are sections (represented by holes) for every category desired. It should be possible to get client classifications for other than mailing purposes from this record. By punching out the appropriate hole, or holes, all of the classifications for each client are definitely established. When a certain group of cards is desired, a manual sort by use of the familiar long needle will collect them quickly and easily.

C.P.A.'s Exempt From Salary Stabilization

Staff members who are Certified Public Accountants have been exempted from salary control by a provision in the Amended Defense Production Act.

The Excess Profits Tax Exchange

Conducted by David Zack, C.P.A.

This department is a clearing house for questions, problems, comments and rulings regarding Excess Profits Taxes. We are especially interested in special and informal Bureau rulings on Excess Profits Taxes. All items of general interest will be published herein and full credit will be given all contributors unless they request otherwise. All inquiries and contributions should be addressed to:

Editor, The Excess Profits Tax Exchange
The New York Certified
Public Accountant
677 Fifth Avenue
New York 22, N. Y.

Adjustment for Inconsistent Position

Section 452 of the Internal Revenue Code should be imbedded at least in the subconscious of the semi-conscious practitioner as he wearily computes an excess profits credit. The section is equally applicable to the income or invested capital method and may be invoked by either the taxpayer or the government. However, this relief provision may only be used as a shield, never as a sword. The law may be used as an equitable defense or counterclaim by the party adversely affected by the inconsistent position, but the Section may never be asserted originally in order to secure a net tax adavantage.

David Zack, C.P.A. and member of the Bar, is a member of our Society and of its Committee on Federal Taxation. He is Chairman of the Committee on Municipal and Local Taxation.

Mr. Zack is a Lecturer on Taxation at The City College (N. Y.) School of Business and Civic Administration and at the New York University Institute on Federal Taxation.

Mr. Zack has written on tax matters for various publications. He is a partner in the firm of David Berdon & Co., Certified Public Accountants.

An adjustment for inconsistent position may be made only when three concurrent conditions exist:—

(1) *An item or transaction must have been incorrectly treated in an earlier year.* "Treatment" does not necessitate a final determination. However, mere urging of a position does not constitute actual treatment on the tax return or later determination. The incorrect treatment may apply to a question of fact or of law.

An error of fact will represent an inconsistent position only to the extent that the facts were known or should have been reasonably anticipated during the earlier year. Subsequently discovered facts will not give rise to inconsistent position and neither will self-correcting errors such as may arise in connection with bad debt and depreciation deductions.

An error of law is determined on the basis of the law applicable to the earlier year as currently judicially determined.

(2) *The prior year must be barred by operation of the statute of limitations or by the doctrine of res adjudicata.* The fact that Section 3801 of the Internal Revenue Code may be applicable does not open the bar to the statute of limitations so as to prevent the adjustment for inconsistent position. However, any correction already made under Section 3801 would be a determination which would have to be incorrect under (1) above.

The fact that the earlier year is closed because of an effective compromise under the statute would not permit an adjustment for inconsistent position. This is due to the fact that a compromise, by its very nature, involves a settlement of the issues in controversy. The determinaion of rec-

ord is purely artificial and, often, necessarily is not on the merits of each specific issue. Many issues are therefore intentionally incorrectly treated in a compromise and it would be difficult if not impossible to apply the inconsistent position statute equitably to this situation.

(3) *A redetermination of the prior year's net income would adversely affect the party taking the inconsistent position in the computation of an excess profits credit under either the income or invested capital method.*

An inconsistent position is taken when the excess profit credit is computed with the prior year's error corrected by the party who would be adversely affected taxwise by the correction of the prior year's error. Mere inconsistent treatment of an item in the determination of current excess profits net income does not consitute the maintenance of an inconsistent position. An unwary taxpayer may easily take an inconsistent position inadvertently but the damage is not irremediable inasmuch as the position is optional and a taxpayer may always withdraw from an inconsistent position. It would therefore seem advisable for the taxpayer always to compute its credit at the highest possible figure. If the taxpayer finds that it inadvertently took an inconsistent position which yields a net tax disadvantage, it may later withdraw from the inconsistent position by a notice in writing. If the Treasury made the error in the prior year, the government would have to claim and maintain the inconsistent position and the taxpayer would be able to offset the additional excess profits tax by a refund of the prior year's taxes plus interest.

The adjustment for the prior year's taxes and interest thereon is part of the computation of the current year's excess profits tax and therefore avoids any bar by the statute of limitations or the doctrine of *res judicata*. The principle is similar to that followed in Section 107 of the Internal Revenue Code and items limited by net income, such as contributions, are recomputed. The current year's excess profits tax may in no event be less than the tax resulting from the adjustment of the inconsistent position. If the adjustment is in favor of the taxpayer, it cannot exceed the excess profits tax for a particular year. An excess is carried over to a succeeding year as an offset against excess profits taxes. A cash refund may never be made, nor may the excess be applied against normal and surtaxes. To the extent that the taxpayer does not have sufficient excess profits tax liability to cover the adjustment, it will lose the benefit of the inconsistent position adjustment.

Interest at the full rate of 6% per annum is included in the adjustment and the interest factor must be included in the taxpayer's return as an item of income or as a deduction in the year prescribed by statute. In the event that the current year's excess profits tax is insufficient to absorb the full adjustment, the tax adjustment is applied first, then the interest factor is absorbed.

The adjustment for inconsistent position may be made for only one excess profits tax year, it may not be reapplied for succeeding years. The adjustment may be made for predecessors and components of the current corporation.

The burden of proof for the application of an adjustment for inconsistent position rests on the party benefitting from the prior year's adjustment. This is the one adversely affected by the adoption of the inconsistent position. Thus, if the adjustment results in an increase of a prior year's income taxes, the burden of proof rests on the Commissioner of Internal Revenue. If the adjustment results in a refund of a prior year's income taxes, the burden of proof lies on the taxpayer. In the event that several years are affected, the adjustments are aggregated and the burden of proof falls on the basis of whether the net result of the adjustments is an increase or refund of income taxes.

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